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MERGERS AND ACQUISITIONS LAW 2010

Top Lawyers on Trends and Key Strategies for the Upcoming Year

Robert C. Knuepfer Jr.

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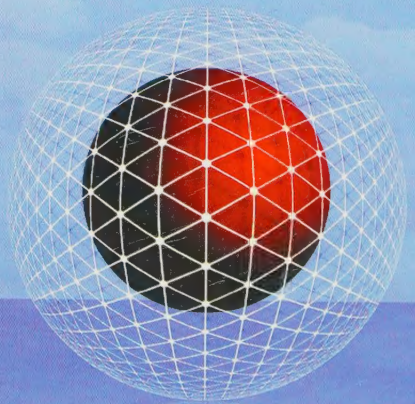

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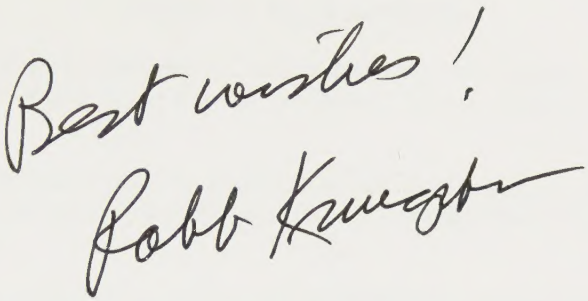
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New Strategies for a New Market in M&A Transactions

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Recent Trends in M&A Law

The unprecedented U.S. financial crisis that began in 2008 and continued into 2009 laid the groundwork for a transformational change in the international mergers and acquisitions (M&A) practice in 2009, and the recognition that we were in a full-fledged global recession. The impact on the M&A arena was evidenced by a switch in focus from a buy-side/up-side market to a sell-side/distressed asset market—the largest change in direction I have seen in my thirty-two years of practice. We probably came very close to a complete global financial meltdown. The bankruptcies of Wall Street giants such as Lehman Brothers, Bear Stearns, and AIG, as well as the auto industry giants GM and Chrysler, led the way for an unprecedented government intervention in the banking and automobile industries. Indeed, many commentators look at the bankruptcies of companies "too big to fail" as merely being the tip of an iceberg for the rest of an economy dependent on these industries.

Because of this near-meltdown, the capital markets froze; consequently, M&A financing was no longer available, which had a spiraling downward impact on all businesses. Business activity was reduced, and unemployment spiked—the U.S. unemployment rate is probably as high as 20 percent in real numbers. Most businesses are currently hunkering down in an effort to generate savings; some need to do so in order to survive, while others would like to seize this opportunity to make new investments, but either market uncertainty or the inability to obtain financing is preventing them. Therefore, while there is some upside in the current M&A market in terms of reduced pricing and good purchase opportunities, there is still limited or no financing available—and as a result, many deals are not getting done.

The Change in Administrations and Its Impact on the M&A Market

Most M&A deals are done on the backs of financial institutions. In most scenarios, there is a willing buyer and seller, and there are strategic reasons for doing a sale or acquisition—either a liquidity event for a seller or an accretive acquisition to enhance earnings for a buyer. All such deals are done on a future-looking basis; the seller typically decides that now is as good a time as any to sell—or they may believe they are selling at the top of the market. Conversely, the buyer in an M&A deal typically believes it is a

good time to buy because the market will continue to go up, and they will be able to absorb the one-time expense of acquiring a company through future growth and development, as well as cost savings or other integrative techniques, such as cost reductions through combined operations. However, now that there is no funding available for M&A deals, that paradigm has shifted completely.

At the end of the Bush Administration and the beginning of the Obama Administration, the focus turned to fixing the financial sector, and like all things in our culture, it seems the pendulum always swings too far one way or the other. In the Bush years, there may have been a tendency to be too liberal or lax in terms of providing credit or financing, as evidenced by the infamous credit swaps, collateralized debt obligations, and other such financing techniques. Ultimately, the financing market got to a point where growth could not be sustained. In reaction to this situation, the government decided that larger capital requirements, bigger reserves, and a tightening of underwriting standards were needed to determine whether a bank would make a loan. However, the pendulum has now swung so far the other way that the new mindset seems to be that if you never make a loan, you can never make a bad loan. As a result, there is no funding available to do what is needed in order to come out of a recession, which is to start growing the economy after the rather dramatic contraction of the last eighteen months.

Under the Obama Administration, a very visible hand is now being exercised in the economy. The legendary TARP and TALF programs were efforts to take toxic assets off the books of our nation's banks, and to remove restrictions on their capital so that they would be in a position to loan more money. However, because U.S. banks have been so severely chastised for past mistakes (i.e., banks that borrowed funds from these government programs must face restrictions on executive compensation until they repay those funds with interest), many banks are currently hesitant about making new loans. Although many banks are once again in a position to loan money, they are afraid they will once again be criticized for loaning money under overly liberal standards.

Therefore, there is something of a Catch-22 situation on the commercial side. Many people have been able to create new products and markets that relate to the funding of TARP or TALF projects; indeed, I have been

involved in setting up some TALF asset purchases that entail buying consumer, student, auto, and mortgage loans in investment pools backed by the U.S. government to take them off the books of commercial banks so that their capital is not impaired. However, all of these programs take time to implement, and even more time to analyze the success of the programs. And, of course, not all of the government relief funds were dispersed, and in some cases, the dispersed funds were used for purposes that did not have a lasting effect on the economy. Time will tell whether the injection of trillions of dollars into the economy is going to make a difference; but right now, the lending market is still largely frozen.

Recent Cases and Decisions in M&A Law: The Fairness Standard

A recent case that has made an important impact on the practice of M&A law was *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, 2009 WL 3165613 (Del.Ch. 2009). In *Hammons*, the Delaware Court of Chancery had an opportunity to clarify the fairness standard in conflict-of-interest transactions involving shareholders. In the seminal case of *Kahn v. Lynch Communication Systems Inc.*, 638 A.2d 1110 (Del. 1994), the Delaware Supreme Court decided that the fairness standard is the appropriate standard of review when a stockholder is on both sides of a transaction. Typically, the rule that applied in an M&A transaction was the so-called "business judgment rule," which confirms that courts do not get into the economics of an M&A transaction and whether it was a right or wrong decision. Rather, a determination is made as to whether the board was acting reasonably in the exercise of its fiduciary duty. Were they exercising their proper business judgment? Did they surround themselves with an appraiser or legal or financial advisers, then consider all the options and make a decision—even if it was not the "right" decision?

Lynch and its progeny affirmed that the fairness standard applies from the beginning of a transaction involving a stockholder who "stands on both sides." However, these cases did not address the situation where the controlling stockholder used its position of control to negotiate for a sale of the company for different consideration than that received by minority stockholders. In *Hammons*, the Delaware Court of Chancery considered this issue and determined that the business judgment rule applied if the transaction was recommended by a disinterested special committee and was approved by the

majority of the unaffiliated voting shares. Courts are taking a somewhat different view of certain transactions. The *Hamilton* ruling provided guidance as to which situations the Delaware courts would apply the more stringent fairness standard versus the less strict business judgment standard.

Material Adverse Change and Effect Clauses

The economy has had a number of impacts on how M&A lawyers handle certain contract issues, including the so-called material adverse change or material adverse effect clauses in contracts. Such clauses essentially promise that the buyer is buying exactly what the seller says they are selling; the seller promises that their assets will still be there at closing, and that there has been no material adverse change in the position or quality of those assets. However, there have been some revisions to these clauses in recent times from a macroeconomic view; now material adverse change or material adverse effect carve-outs guarantee a company's assets except in cases involving adverse changes to the U.S. economy or in a particular industry, or due to an act of terrorism. These new exceptions did not exist prior to the meltdown.

Similarly, another change that has emerged in this area pertains to what lawyers like to call "sandbagging" (i.e., an indemnity wherein the seller indemnifies and holds the buyer harmless for not revealing some event they should have disclosed. Sometimes the indemnity is excluded if the buyer obtained knowledge of a breach during their due diligence and did not say anything about it, and the seller did not know about it. For example, during due diligence, the buyer may call the seller's major customer and ask, "Are you going to continue to do business with this company after we buy them?" The customer says "No," but the buyer does not inform the seller about the conversation. They then buy the seller's company, and later claim a breach because they lost a major account. However, if the buyer knew they would lose the account before the transaction event occurred, it is not fair to hold up the seller for a claw-back on the purchase price.

Fiduciary Exceptions

Another emerging trend that is likely to come up in many M&A cases in the coming year involves what is called a fiduciary exception, which pertains to a situation where a board of directors that is committed to sell its company

to Buyer A gets a superior offer from Buyer B. The board may have already gone down the path of saying, "We are going to sell to Buyer A, and if we do not, we will give Buyer A a break-up or termination fee for their banking, legal, and due diligence expenses, up to the point where we do not close." For example, the board gets a better offer, but has agreed to pay a substantial break-up fee to Buyer A to cover their costs in the event that the deal does not close.

In the recent case of *Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008), the Delaware Chancery Court held that the buyer had knowingly and intentionally breached the merger agreement by failing to use reasonable efforts to consummate financing, despite a "no financing out" clause in the merger agreement. By contrast, in *Alliance Data Systems Corp. v. Blackstone Capital Partners V L.P.*, 963 A.2d 746 (Del. Ch. 2009), the Delaware Chancery Court held that there was no breach of the merger agreement by the buyer for failure of the buyer to induce a non-signatory to provide additional capital required by regulatory authorities.

In some cases, however, there has been a carve-out for boards that are exercising their fiduciary duty to give the owners of the company a better offer; and some fiduciary exception clauses have also been expanded to accommodate this new distressed M&A economy, with respect to failure to obtain financing. Simply put, given the risk that buyers are not going to get financing, it is often hotly debated as to whether a seller who does not have much commercial choice is going to provide a termination fee if the buyer is not able to go through with the deal on their end. Therefore, the seller will sometimes tweak the termination fee to say, "If you do not get financing, there is a penalty, and as the seller, we get X dollars for a blown deal." Essentially, this is an exclusive remedy (i.e., "You do not get to sue us for specific performance or anything else, or we will provide financing, but that is the total extent of your remedy.").

In the recent case of *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009), the Delaware Supreme Court held that the directors acted in good faith in the sale of the company, citing the use of disinterested and independent directors who were supported in their deliberations by financial and legal advisers, despite claims that they acted hastily, failed to negotiate better terms, and failed to seek superior offers.

Double Materiality, Willful Knowledge, and Other Exclusions

Another nuance in many M&A contracts these days is the double materiality clause if a transaction has a post-closing indemnity. Under such a clause, the seller promises that they own the inventory as valued on the balance sheet; that it is true and correct as of the closing; and if it turns out after the fact that there was a mistake in relation to that inventory, it has to be material enough to trigger a refund, payment, or indemnity. However, most M&A attorneys are now excluding the materiality concept from the calculation of whether there is a loss; you base it at zero from the day of closing, and anything that is off that calculation gets counted toward building up to the materiality level. For example, if materiality is defined as anything in excess of $100,000, you cannot start counting until $100,000; and when you get to $101,000, if you have to go back to zero for the next occurrence, it is "double counting" for all claims. The current preference is that the amount is cumulative, so the next occurrence is in addition to the amount of the prior occurrence. That way, the buyer gets credit for all occurrences, and does not have to trigger the materiality level with each occurrence.

Yet another change I have seen in M&A documents relates to the so-called "willful, knowing, or intentional" clause (i.e., anything a seller does that was willful, knowing, or intentional in terms of disclosure is actionable). However, this concept has never been defined; rather, it seems that you simply know it when you see it. For example, a chief financial officer of one of the companies in a transaction may say, "I knew the books were cooked." Indeed, I have recently seen three deals where the parties were essentially writing in their own definitions of "willful, knowing, and intentional" in relation to a transaction.

There is also often an exclusion of third-party beneficiaries and indemnities in M&A contracts (i.e., if there is a problem with the acquisition, the buyer only has a right to go after the company; and if the seller has to make a payment under an indemnity or otherwise, it goes to the benefit of the buyer company, not to its shareholders). This is a problem if the selling company has been disposed of by merger or dissolution, and only the former shareholders remain as beneficiaries of a claim. The parties frequently treat this circumstance with a carve-out or exception to the exclusion of third-party beneficiaries.

Timing of Representations and Warranties

The timing of representations and warranties on a bifurcated closing are also changing. Sometimes a deal is closed weeks after the signing; you may want to lock up the purchase contract, but if it is subject to regulatory approval, bank financing, or getting signatures from other people, there will be a two-step closing process.

The dilemma in such situations pertains to the promises in the representations and warranties to the buyer that were made at the signing (i.e., do they need to be updated as to the actual closing?). It is important to determine when a title transfers; and depending on the length of the gap between the signing and closing dates, serious issues could arise, especially in relation to today's volatile markets For example, a financing commitment may be withdrawn after signing. Therefore, I am seeing more cases where the representations and warranties in an M&A contract are certified to be true when made at the signing, and brought down to the closing, however delayed that closing may be.

Earn-Outs

Earn-outs are a hot topic today, because you cannot get financing in many M&A deals, and there are often distressed sellers involved in these transactions. For example, I recently did a deal in which the seller of a service company thought his company was worth $50 million; the buyer was not sure if that was a correct valuation, but wanted the owners to keep operating the business after the sale. Ultimately, the buyer agreed to pay the seller $25 million, which was only 50 percent of the seller's perceived value, and the seller agreed to take that amount on the understanding that if the company performed after closing to a pre-agreed level, the seller would not only get the other $25 million, but also an upside price beyond that, capped at $75 million.

Basically, this type of earn-out strategy is a way to get full value in a distressed economy in a scenario where the buyer and seller in an M&A transaction are far apart on value; and it is, in effect, a sort of seller financing. Simply put, the buyer in my example only has to pay half the seller's desired value, and maybe finance some or most of that amount; and

future earnings are used to pay the seller what they thought was full value at the time of the sale.

A recent case that provides an interesting example of such an arrangement was a Massachusetts case affirmed in October 2009 by the First Circuit Federal Court of Appeals. *Sonoran Scanners Inc. v. Perkinelmer Inc.*, 585 F.3d 535 (1st Cir. 2009), involved an entrepreneur who spent $3.5 million of his life savings to create a scanning product, and then had no capital to market it. He sold the product to PerkinElmer for $3.5 million cash at closing, and an earn-out on sales over the next five years. The buyer did nothing with the product, the business failed, and there was zero earn-out. The seller then sued PerkinElmer, and the Court of Appeals held that if someone buys an exclusive right to manufacture something under a patent, there is an implied obligation to use reasonable efforts to promote sales. If a company employed numerous salespeople to promote a product, and nobody wanted to buy it, the seller would have no recourse. However, in this case, the court ruled that not promoting the seller's product was a way to take advantage of a seller who had an expectation of full value based on an earn-out; and if the buyer does nothing to promote the product, there will be no earnings to pay the seller.

Global M&A Trends

We are now in a global economy; therefore, the main action in the M&A market over the past few years has been in international M&As. However, big M&A markets such as Asia (particularly China), Europe, and India are really suffering these days. During the first three quarters of this year, China was down some 34 percent to $100 billion in total foreign investment. However, if you were to visit China, where we have five offices, you would not think there is a recession; in fact, China's gross domestic product is on track to increase by more than 7 percent this year, and there is a lot of building going on in places like Shanghai.

Nevertheless, certain events have hurt the Chinese M&A markets; for example, the Chinese government denied Coca-Cola's bid for the China Juice Group, a $2.5 billion offer. Chinese outbound investment in terms of buying U.S. companies is down by 50 percent, to almost $10 billion. Indeed, the Chinese government has exhibited a great deal of cautiousness

in exploring and developing experience in M&As, and the closure rate is dismal; Chinese companies have closed only one of three deals. Similarly, other governments have stopped Chinese investments. Chinalco tried to buy Rio Tinto, the Australian mining conglomerate, for $19 billion in June 2009, and that deal was rejected. In July 2009, a Chinese auto company wanted to make a bid for Opel as part of GM's restructuring, but GM refused, because they were afraid the new company would compete with their Chinese automotive business.

There is a similar M&A slowdown in India, largely due to the terrorist attacks at the Mumbai hotel and the advent of a new government in May 2009. M&As in Europe are also generally down across the board. Therefore, the opportunities in global markets are hampered, and that has contributed to the global recession.

Looking to the Future: New Financing Strategies

Our clients are basically hunkering down. We are seeing the return of the earn-out strategy in M&A deals, as previously noted, because in many cases, you cannot go to a bank to get a full-value financing—you may only be able to get financing for half value, and you can then let the earnings of the target company finance the rest of the deal. Such a strategy really shifts all the risk to the seller, because if the buyer does not make sufficient numbers from the seller, the seller does not get paid the extra premium. However, this is a deal many sellers are increasingly willing to accept these days. For example, the owners of a privately held company may be seeking retirement; they do not want to work another five years or more until we come out of this recession. They may rationalize, "I am selling at a low price, but if the business sustains itself, we will get more money."

We used to do such deals twenty-five years ago, during the leveraged buyout, pre-private equity financing era. In existing private equity deals, many companies are really just trying to repair the damage to their portfolios; many of their operating companies have had major declines in recent times, particularly in manufacturing. Some of our clients have suffered revenue losses of 25 to 65 percent; they are laying off people, making 25 percent cuts in compensation, and not buying new capital equipment because they do not have orders to fill.

We may be going through a "double-dip" recession, as it is often called; we have definitely hit the bottom, and we are now starting to come back up. In the first quarter of 2010, we are seeing much more M&A activity than we have seen in the last year, largely due to a combination of the thawing of the credit markets and the re-pricing of assets. Simply put, greater availability of credit and cheaper values are once again enabling people to make some deals.

The second trend I see in this area is that more companies are cleaning up their inventory of assets. In accretive years when companies were doing a lot of buying, it was not as important to trim the dead wood, but now it is "house cleaning" time. In a booming economy, the house cleaning would not yield the same pricing as in a distressed economy, because the motivation for the seller in a down economy is more likely to be that they simply do not want to keep a particular business unit; therefore, they are willing to sell without getting a significant multiple. They just want the unit off their balance sheet—and that is creating buying opportunities at reduced prices. Therefore, if you cannot get outside financing for M&A deals, you may be able to get inside financing; I am seeing sellers who are saying, "I will give you five years to pay me X dollars plus interest."

Looking ahead, the American Bar Association is planning to come out with some new model M&A documents next year; one is a model stock purchase agreement, and another is a model merger agreement for public companies. Those documents will provide some new industry standards that will address many of the issues I have discussed.

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Creating New Strategies for M&A Clients in a Challenging Market

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Recent Trends in M&A Transactions

This has been one of the slowest merger and acquisition (M&A) markets we have had in the last twenty years, although it has picked up a bit in recent times. The biggest factor in this slowdown has been the turndown in the economy, which has led to a lack of liquidity. Indeed, the state of the economy—rather than any changes in laws, decisions, or policies—is the cause of the current lack of deals and transactions; and the few deals that are being done have generally been subject to greater scrutiny by government regulators in certain areas.

Because of increased scrutiny in this area, greater attention is being paid to the early stages of an M&A transaction. More often, deal terms are being negotiated earlier in the M&A process, such as in the letter of intent and the term sheet. There may be more closing conditions in the term sheet, for example, as well as more overall limitations on liability. Generally, there has been more focus on increasing due diligence and on negotiating more of the terms of an M&A deal, due to the fact that clients may wish not to expend resources unless they know they have a deal going forward. Without financing, many M&A deals have not closed or even gotten past the letter of intent stage.

Looking ahead to 2010, I believe that even if the economy gets better and deals pick up, attention will continue to be focused on some of the lessons we have learned with respect to the challenges and issues that have occurred in this area in recent times. For example, sellers will still inquire as to the buyer's ability to close the transaction even if the debt markets improve. Government regulators played a much bigger role in the M&A landscape in 2009, and will probably continue to do so in 2010. Banking segment regulators, for example, have been involved in putting together transactions such as the Merrill Lynch/Bank of America deal and proposing significant restrictions on compensation of executives. Indeed, regulators are becoming regular and active "participants" in M&A transactions, which is a further development in this area. For example, financial institutions that have received funds from the federal government (i.e., the Troubled Asset Relief Program or TARP) must comply with such additional restrictions imposed by TARP. Consequently, many companies and their lawyers are seeking out regulators earlier on in the M&A process to see if their deal will

happen, and some of the closing conditions that ordinarily would get negotiated later on in the process are getting negotiated earlier. In some cases, our clients must ask regulators to tell us what the closing conditions are, should be, or can be in order to get a deal done, or whether the regulators will approve the new management and their compensation. In a recent transaction, the capital requirements for the target post-acquisition were negotiated and approved by the regulators. Simply stated, regulators are playing a much bigger role in the banking and financial institution areas in terms of their involvement in putting M&A deals together, reviewing deals, and determining how deals get done and whether those transactions will get approved; and this is true to a much greater extent than we have seen in the past.

Working with Clients in a New M&A Environment

The main topics we discuss with our M&A clients include the question of whether they should or can do a particular deal, and whether there are any financing conditions, liquidity concerns, or timing issues that should be considered. Those issues have always been part of our early discussions with clients who are trying to sell their companies or trying to acquire another business, but we are spending more time discussing those topics these days.

One trend I have observed on a regional basis is a growing number of companies that are simply closing their doors, or franchisees walking away from franchise agreements; whereas in years past there might have been a transaction or sale, or at least a bankruptcy filing or liquidation process. In certain circumstances, the client decided that an M&A transaction was not feasible in the current economic climate. I am also engaging in many client discussions with respect to collateral M&A issues involving facilities and employees (i.e., which offices or facilities do we close or attempt to renegotiate the lease terms, and which employees do we lay off?). There is a growing sense among many M&A clients that even after entities are combined, revenues might be flat or decreasing; consequently, there is more of a focus on the cost side of the combined entities, and how to reduce those costs. Cost issues have always been a part of M&A deals, but these days you really need to focus on cost savings and synergies in M&A transactions. Therefore, cost issues should be a part of any early M&A discussions.

Another key issue is where the financing is required to complete the transaction. When you are representing a buyer, you need to know if they are in a position to do the deal without financing—and if they are not, what type of financing contingency do they need, and how do they get the seller comfortable with that arrangement? This discussion is essential, because if an M&A client needs financing in this market, it is difficult to move forward unless they already have that financing lined up or they have readily available cash.

Indeed, there has recently been more focus on the investors in an M&A deal on both the buyer and seller side. For example, are the investors venture capitalists or private equity funds, and is there a lack of liquidity on either side? There are probably going to be fewer venture capitalists and private equity funds in 2010, and it remains to be seen if this trend will lead to more fire sales, or whether investors are going to try to hang on and fund their existing companies. Consequently, we are asking more questions in terms of diligence with respect to our own clients and their potential targets, whereas in the past we might have simply assumed that a deal would occur. These days, many deals are started and then put on hold or changed; the parties may want to renegotiate for some reason, or there may have been some changes in the client's business that will cause us to reexamine a deal. As a result, it is generally taking longer for most deals to get done.

Key Cases in M&A Law

A key case in the area of recent M&A law is *Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008), where the buyer attempted to terminate the transaction because the seller had suffered a "material adverse effect." Basically, the court in this case decided—in a decision consistent with decisions in many prior cases—that there was not, in fact, a material adverse change or event that caused the break-up of this deal, and that the buyer had not met their burden in demonstrating this occurrence. Indeed, courts generally do not unwind transactions on those grounds, because they are to some extent subjective—and it is always hard to be objective in these situations unless there is a definite formula or ratio that was specifically included in the transaction document.

Therefore, the outcome in this case represents a continuing trend in this area. I do not think the decision in *Hexion vs. Huntsman* has affected how we

draft material adverse change or adverse effect clauses, but it has led us to reexamine whether we are going to use a covenant with respect to best efforts to obtain financing, as opposed to a closing condition. If there was a financing closing condition in the *Hexion* transaction, the buyer may have terminated the deal, because the closing condition was not satisfied. Conversely, it is more difficult to get out of a material adverse change or condition covenant; again, the courts do not typically want to disrupt those types of transactions, because the provisions are construed narrowly and case law supports transactions going forward and not getting terminated based on a material adverse change.

Lyondell Chemical Co. v. Ryan, 970 A.2d 235 (Del. 2009), is a Delaware Supreme Court fiduciary duty case involving a transaction that came together quickly over just a few days where the seller did not seek competing bids and agreed to certain "lock-up" provisions. Ultimately, the court found that the directors properly approved this transaction. Indeed, the question in this case was not whether the directors did everything possible and then came up with a perfect decision; rather, the court ruled on whether the directors took reasonable efforts and did their job in terms of trying to come up with a reasonable transaction in light of the circumstances. There was a significant premium paid in this transaction, and it came down to whether the court wanted to second-guess the directors (i.e., since they got a 50 percent premium over the current stock price in this deal, should they have tried to shop it to other buyers and potentially lose the deal?). Ultimately, the court ruled that it did not want to second-guess what happens in the boardroom as long as the process is complete, and as long as the board takes reasonable efforts to make sure a good decision is reached.

Because of this decision, we continue to counsel the boards of our clients that they have fiduciary duties to the company and their shareholders, and they need to exercise them. M&As are not always black and white, but a company's directors need to be focused and interested, and listen to their advisers in order to make good decisions. Indeed, the courts are generally not going to overturn any decision a company's directors make in the course of an M&A transaction as being a good decision; rather, they are going to focus more on the decision-making process in terms of what the directors did and how they did it. The business judgment rule continues to be respected.

In summary, these cases indicate that how you draft provisions in an M&A deal is important, but the fundamental decisions by buyers and sellers are equally important. Therefore, as you deal with directors who are approving transactions, you need to remind them of their duties in the process, and make sure those duties are followed through on. At the same time, it is important to keep in mind that the courts will not usually upset or terminate transactions unless there are significant reasons to do so. These situations generally occur when boards are asleep, not asking questions, and not observing the process in a significant way.

Pending M&A Law Decisions

Because of the Merrill Lynch/Bank of America transaction, there has been a lot more scrutiny in this area, as previously noted. Indeed, it was recently reported that Bank of America needs to produce many more documents with respect to legal advice they got in connection with this transaction. Ultimately, if this trend continues, there may even be a waiver of attorney/client privilege in these cases, or a significant review of advice that lawyers gave to companies in connection with such transactions—and there may be some novel outcomes if the courts do in fact find that the advice given in some transactions was not good advice, and companies should not have relied on that advice.

There is currently a lot of political pressure aimed at taking a closer look at those M&A deals where executives are paid a lot of money in salary or bonuses, especially if disclosures in that area may not have been complete. As a result of these issues being raised, some settlements or transactions have not been accepted, and further scrutiny has been focused on what happened in an M&A deal and how it happened, and the role lawyers played in the process.

Changing Strategies

Government regulators now have greater involvement in banking transactions than was the case in years past, as previously noted, because many banks are either in trouble or under-capitalized. Consequently, our clients have often had to consult regulators a little earlier in the M&A process to see if a banking client's transaction is one that they would

approve. Accordingly, we have counseled our banking M&A clients to be mindful of how regulators would view their transaction; in fact, the closing conditions for a bank M&A can come directly from government regulators who are looking at the viability of a bank post-acquisition. Indeed, the advice we give and the timing of the various steps in the M&A process often depend on the client's particular industry and their particular transaction; if an industry has specific challenges or is subject to government regulation and scrutiny, as is the case in the banking industry, we have to be mindful of that fact.

Increasingly, corporate and in-house counsel are looking to alternative billing arrangements or flat or fixed fees, particularly in the securities compliance area. Managers are making cuts in their legal budgets, and chief financial officers are looking for predictability in their legal and other expenses. Fixed fees have become more common when handling certain types of transactions, and it remains to be seen if, going forward, M&A law will continue to be considered a specialty that is billed on an hourly basis or through alternate billing arrangements. Investment bankers and certain advisors generally receive a success fee upon the closing of an M&A transaction. More law firms may look at this model and other alternate fee arrangements.

If the initial public offering market is still down or declines further in the year to come, it is possible that more people will start to look toward acquisitions, roll-ups, or other strategies to try to get some liquidity. Some may look at deals in foreign markets or exchanges, and some foreign buyers may decide to come into the U.S. market. Indeed, in certain industries, the traditional buyers are gone and may never come back, and that presents opportunities for new types of buyers, new types of financing, and new types of deal structures. Many investors need liquidity, and many owners need to sell, and it remains to be seen who the buyers and M&A players are going to be in the coming year. Some of the traditional buyers are testing the waters and coming back into the market now, but a lot are still on the sidelines.

Looking to the Future

Looking ahead, it is likely that a new administration and the additional government regulation that typically goes along with receiving stimulus money and other government funding will have a wider impact on industries that have

not been regulated before, such as hedge funds. Bigger government, more regulation, and the need for government approval may make some transactions a bit harder to come by; stimulus money generally comes with some strings, and time will tell whether that impacts certain M&A transactions.

If there is a change in the capital gains tax or other tax rates that could affect many transactions in terms of how they are structured, some may need to be tax-deferred or reorganized. Further liquidity challenges in the stock market may make a cash deal preferable to a deferred deal, but sellers who want to get their price may need to defer payment or take a note or earn-out; indeed, in many of these types of transactions, it may be increasingly common for sellers to get paid over time as financial and performance projections are met. There is still a lot of uncertainty in this area, but as many of those uncertainties start to get resolved, those solutions will influence how we advise our clients on M&A transactions.

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Recent Developments and Trends in M&A Transactions

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Background

Mergers and acquisitions (M&A) activity in 2009 was adversely affected by multiple factors, including the restricted availability of credit, the caution of strategic buyers, low stock prices that reduced the value of securities as acquisition currency, and the failure of sellers to adjust their valuation expectations to the new environment.

The challenging environment at the end of 2008 and throughout 2009 led to many broken deals as financing could not be obtained on terms originally contemplated and business conditions deteriorated, prompting many buyers to seek to renegotiate or exit transactions. The ensuing litigation resulted in courts being called upon to interpret and test the limits of provisions that have become standard in M&A agreements and practice.

Conditions in the credit market and the challenging economic environment led to a great deal of uncertainty and made it difficult to negotiate and complete transactions. These conditions are likely to continue into 2010. A great deal of cash is reportedly waiting to be deployed, but the environment is likely to be characterized by caution and conservatism on the part of both acquirers and lenders.

M&A activity in 2009 played out against a background of increased shareholder activism and public anger at excessive executive compensation. This is likely to result in increased political and public scrutiny of transactions involving public companies when the market recovers.

Current Strategies and Developments in M&A Practice

Throughout 2009, companies were cautious in pursuing transactions and were very risk averse. Potential buyers asked their attorneys and other professional advisors to conduct more comprehensive and extensive due diligence in all areas, including areas where they may have paid less attention in the past and relied upon an indemnity; for example, in the area of foreign corrupt practices and other areas where there is the possibility of government enforcement and penalties.

In this environment, the challenge for deal lawyers was and continues to be to find a path that takes into account the buyer's need for assurances on fundamental elements of value without making a transaction unachievable from the seller's perspective. More than ever, clients are looking to their attorneys for a practical and realistic assessment of their due diligence findings, and an evaluation of downside risks under different scenarios and ways to protect against these in their acquisition agreements.

Due to the uncertain economic conditions, buyers have become very intent on preserving their ability to exit a transaction where circumstances that affect fundamental assumptions concerning the seller and the transaction change after signing the acquisition agreement. Much more than in prior periods, attorneys and clients are now drafting specifically to protect an exit at minimal cost. This has resulted in the inclusion of more specific contingencies as closing conditions to address these issues, greater focus on the amount of termination fees, and the circumstances under which termination rights can be triggered.

Because of the credit crisis and the uncertainty that even strong strategic buyers faced in obtaining funding, concepts that originated in private equity transactions have migrated to strategic transactions. For example, the concept of the reverse termination fee that originated in private equity to limit the liability of sponsors for failure to consummate a transaction has been applied with some modifications to cap the liability of a strategic buyer for failure to close a transaction due to the inability to obtain financing. This technique is likely to be featured in strategic debt financed acquisitions for as long as current credit conditions prevail.

The absence of many potential buyers from the M&A market has made it especially challenging for sellers. The auction process continues to be utilized, but the need for transaction momentum from the seller's standpoint is in conflict with the caution of many buyers. Sellers have been setting milestones that the successful initial successful bidder must continue to meet in order to maintain exclusivity. For example, sellers are asking buyers to reaffirm their interest in the transaction after completion of various stages of due diligence and even to deposit amounts that can be held as security.

To complete transactions, sellers have been more willing to provide some form of seller financing to bridge funding and valuation gaps through the acceptance of a promissory note from the buyer. In addition, sellers have accepted an earn-out mechanism as a way to bridge differences in valuation expectations.

The terms of transactions that involve public companies have been subjected to a greater degree of political and public scrutiny, with particular attention being paid to the benefits that are being received by executives of the target company as part of the transaction. These issues must be addressed far in advance of a potential transaction as part of a company's executive compensation practices, and attorneys are assisting clients in the review of these elements of their programs.

In light of the recent controversy surrounding the payment of bonuses to employees of institutions that received federal assistance and the withholding of that information from shareholders of Bank of America in connection with its acquisition of Merrill Lynch, public companies may be expected to provide greater disclosure of information that is contained in schedules to acquisition agreements, in particular the terms of executive and senior employee benefits that may be deemed material to shareholders.

Recent Decisions Affecting M&A Law

The Delaware courts have decided three important cases that affect M&A law and practice since the beginning of the credit crisis. Two of these cases arose out of broken deals involving private equity sponsors and were decided by the Court of Chancery—*Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008), and *Alliance Data Systems Corp. v. Blackstone Capital Partners V L.P.*, 963 A.2d 746 (Del. Ch. 2009). The third case—*Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009)—was decided by the Delaware Supreme Court and addressed the proper analysis of breach of the fiduciary of loyalty claims in connection with a sale of the company.

Hexion Specialty Chems. v. Huntsman

This case arose out of a suit filed by Hexion, which was 92 percent owned by the private equity fund Apollo Global Management LLC, that sought a

declaratory judgment, among others, that a decline in the seller's performance after the signing of its merger agreement with Huntsman constituted a material adverse effect (MAE) that excused Hexion's performance of its obligations under the merger agreement. Hexion also sought a declaration that, in any event, its liability was limited to $325 million, which was the liquidated damages payable in all events other than in the case of a knowing and intentional breach of the merger agreement. Huntsman counterclaimed seeking a declaratory judgment that no MAE had occurred and that Hexion had knowingly and intentionally breached the merger agreement. Huntsman sought an order that Hexion specifically perform its obligations under the merger agreement or, if it failed to do so, an award of full contract damages.

Although the decision is perhaps most well known for its holding that Hexion had knowingly and intentionally breached the merger agreement and was potentially liable for uncapped contract damages, the long-term significance of the decision is the further insight provided into how Delaware courts will interpret MAE clauses in the context of M&A agreements. The decision sets forth three principles that will be of significance to M&A practitioners in the future.

First, the court reaffirmed the framework for analyzing MAE conditions that was developed in *In re IBP Inc. Shareholders Litigation* in which the Delaware Chancery Court had applied New York law to interpret an MAE clause. 789 A.2d 14 (Del. Ch. 2001). Essentially, this is to view the MAE condition as a "backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner." Accordingly, the first step in an MAE analysis is an assumption that, in the absence of evidence to the contrary, an acquirer is purchasing the seller as part of a long-term strategy. The second step is the question of whether there has been an adverse change in the seller's business that is "consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months." A decline in earnings after signing and prior to closing is relevant only to the extent that the poor earnings results are expected to persist significantly into the future.

Second, absent clear language to the contrary, the Chancery Court determined that the buyer should bear the burden of proof of establishing that an MAE has occurred with respect to the seller.

Third, the decision clarifies how the seller's projections may factor into the MAE analysis. The definition of the MAE clause in the merger agreement at issue in the *Hexion* case included standard language that referred to any effect that is materially adverse to the "financial condition, business, or results of operations" of the seller and its subsidiaries, taken as a whole. The Chancery Court rejected Hexion's contention that the seller's failure to meet the projections provided in the sales process constituted an MAE on two separate grounds. Firstly, the merger agreement expressly disclaimed any representation or warranty by Huntsman with respect to "projections, forecasts or other estimates" and specifically allocated the risk to Hexion that Huntsman's performance would not live up to management's expectations at the time. Second, the Chancery Court agreed with the analysis of Huntsman's expert that the phrase "financial condition, business, or results of operations" was a term of art taken from Regulation S-K of the Securities and Exchange Commission that requires a comparison of each year and quarter to the prior year's equivalent period. Based on a comparison of these periods in 2007 and 2008, it was clear that no MAE had occurred, since even using Hexion's estimates Huntsman's 2008 EBITDA would be only 11 percent below its 2007 EBITDA. None of the periods reviewed by the Chancery Court demonstrated that Hexion had met its burden of proof that Huntsman had suffered a long-term impairment of its earnings potential.

Fourth, the merger agreement definition of MAE contained a carve-out that would exclude from the determination effects that resulted from conditions affecting the chemical industry generally, unless they affected Huntsman disproportionately to other participants in the chemical industry. The Chancery Court determined that the correct analysis of this clause (and, by implication, other disproportionate effects clauses) is first to establish whether an MAE with respect to a seller has occurred. If a buyer cannot meet this burden, a court does not even have to consider how the seller has been affected relative to other industry participants. Accordingly, even if it could be shown that conditions in the chemical industry affected Huntsman disproportionately, this would be relevant only if Hexion had been able to establish that Huntsman had suffered an MAE.

These principles clarify important elements of perhaps the most important term in many M&A agreements. The Chancery Court's analysis reaffirms that, absent express language that modifies the common generic definition, buyers will continue to face almost insurmountable obstacles to asserting the MAE condition as a reason not to close a transaction. In response to the *Hexion* case, buyers have begun to negotiate more narrowly tailored MAE clauses in place of the generic standard definition, a trend that may be expected to continue into 2010.

Alliance Data Systems Corp. v. Blackstone Capital Partners V L.P.

The *Alliance* case required the Chancery Court to resolve a claim by a seller that a buyer was liable for damages under an acquisition agreement on the basis that it had failed to cause its private equity sponsor, which was not a party to the agreement, to take certain actions to complete the merger.

The *Alliance* case does not articulate any new principles of law. However, it reaffirms in the context of a typical private equity transaction structure that the Delaware courts will enforce the express terms of the merger agreement when interpreting the obligations of a private equity buyer and its affiliated entities to complete a transaction.

At issue in the *Alliance* case was whether the buyer, a wholly owned subsidiary of its private equity sponsor Blackstone Capital Partners V L.P., was obligated to cause Blackstone, which was not a party to the merger agreement, to obtain the approval of the Office of the Controller of the Currency (OCC). The relevant covenant provided that each party would use its reasonable best efforts to take, or cause to be taken, all actions necessary to consummate the transaction. The seller argued that this covenant required the buyer to cause Blackstone to obtain OCC approval. The court rejected this argument because the unambiguous language of the covenant did not impose any obligation on Blackstone to use any effort or the buyer to cause Blackstone to use any effort. The court found that the buyer itself had attempted to satisfy the demands of the OCC and in doing so had satisfied its contractual commitments to use reasonable best efforts to secure OCC approval.

The court in *Alliance* rejected the seller's three other arguments in support of its claim that the buyer had breached the merger agreement, all of which,

in the court's view, were inconsistent with the plain language of the merger agreement, including the argument that the buyer had breached an implied covenant of good faith to cause Blackstone to obtain OCC approval since this would "impose an after-the-fact obligation on [the buyer] that [the seller] was unable to obtain in the contractual obligation and contradict the plan terms of the merger agreement."

The *Alliance* case illustrates the importance from the seller's perspective of ensuring that it contracts with the appropriate entity in the private equity group, or at a minimum, ensures that a contracting party to the agreement undertakes to cause a non-contracting party to take those actions under the acquisition agreement that are material to the completion of the transaction.

Lyondell Chemical Company v. Ryan

In *Lyondell v. Ryan*, the Delaware Supreme Court examined the question of whether a board of directors had acted in conscious disregard of their duties when they approved a sale of the company.

In May 2007, an affiliate of Basell AF filed a Schedule 13D with the Securities and Exchange Commission disclosing its right to acquire an 8.3 percent interest in Lyondell and its interest in a possible transaction with the company. The Lyondell board convened a special meeting, recognized that the filing of the 13D signaled to the market that the company was "in play," and determined to take a "wait and see" approach. On July 9, 2007, Basell made an offer to purchase the company at a price of $48 per share. The offer was not subject to a financing contingency but was conditioned on a $400 million break-up fee and signing a merger agreement by July 16, 2007. At a special meeting of Lyondell's board on July 10, 2007, which lasted for slightly less than one hour, the board considered valuation material prepared by management and authorized Dan Smith, its chairman and chief executive officer, to obtain a written offer and details concerning Basell's financing. The board met again on July 11, 2009, also for less than one hour, to consider the proposal, engaged a financial adviser, and instructed Smith to negotiate with Basell. In the course of negotiations from July 12 to July 15, 2007, the board instructed Smith to seek an increase in the price, a reduction in the break-up fee, and a "go-shop" provision. Basell agreed only to reduce the break-up fee to $385 million. At a final

special meeting on July 16, 2007, the Lyondell board received presentations from its financial and legal advisers. The financial adviser opined that the $48 per share was fair and explained why it believed no other potential acquirers were likely to top Basell's offer. A managing director of the financial adviser described the price as "an absolute home run." The board voted to approve the merger at the meeting, and on November 20, 2007, the merger was approved by more than 99 percent of the shares voted.

A class action complaint was filed challenging the merger on grounds, among others, that the Lyondell board had breached their fiduciary duties of care, loyalty, and candor. The Chancery Court granted summary judgment to the defendants on all of the plaintiff's claims with the exception of claims directed at the sales process and the deal protection provisions in the merger agreement. On these claims, the Chancery Court denied summary judgment because it wanted to obtain a more complete record before deciding whether the directors had acted in bad faith. The Chancery Court was troubled by the record that the merger was negotiated in less than a week during which time the board met for less than seven hours and did not seriously press Basell for a higher price nor conduct even a limited market check. According to the Chancery Court, the record raised the specter of bad faith because, for a period of two months after the filing of the Schedule 13D, the board did nothing "to arm themselves with specific knowledge about the present value of the company…despite admittedly knowing that the 13D filing put the company 'in play,' and therefore, presumably also knowing that an offer for the sale of the company could occur at any time." The Supreme Court's holding in response to this line of analysis is significant in several respects.

First, the Supreme Court rejected the assumption underlying the Chancery Court's analysis, which was that the board's duties under *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d. 173 (Del. 1986), require the directors to confirm that they have obtained the best available price by conducting an auction, conducting a market check, or demonstrating an impeccable knowledge of the market. Under the Supreme Court's analysis, there is only one *Revlon* duty, and that is to get the best price for the stockholders on a sale of the company. Only a board of directors in response to the unique combination of circumstances of the particular case can formulate the appropriate strategy and accomplish the goal.

Accordingly, the case reaffirms that there is no blueprint a board of directors must follow when approving the sale of the company.

Second, the Supreme Court clarified that *Revlon* duties do not arise solely because a company is "in play." They are triggered by the decision to embark on a transaction that will result in a change in control whether on the company's own initiative or in response to an unsolicited offer. The Chancery Court had mistakenly analyzed the situation confronting the Lyondell board on the basis that *Revlon* duties applied to the board when the potential acquirer filed its Schedule 13D and put the company on notice that it was interested in acquiring Lyondell. It focused on what the board did not do in the two-month period after the filing of the Schedule 13D rather than what it did in the period of one week when *Revlon* duties applied. That period began when the board started to negotiate the sale of Lyondell.

Third, the Supreme Court articulated the framework for the analysis of claims that a board of directors has breached its duty of loyalty by failing to act in good faith in connection with its approval of a sale of the company. The court's analysis is significant, because in the view of many commentators, the ruling by the Chancery Court appeared to imply that, under circumstances where the company may have engaged in a flawed sales process, the decisions of a disinterested and independent board of directors could be subject to challenge as a non-exculpable violation of the duty of loyalty rather than a violation of the duty of care that was exculpable under Section 102(b)(7) of the Delaware General Corporation Law. Del. Code Ann. tit. 8, § 102(b)(7) (West 2009).

The Supreme Court's analysis of claims that the directors acted in bad faith in approving a sale of the company is as follows. First, bad faith requires more than that the directors failed to do all they should have done in the circumstances. Any such failure would be a violation of the duty of care but would not of itself amount to bad faith. Second, bad faith is present if a "fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." In other words, it requires that the directors knowingly and completely fail to undertake their responsibilities. Third, in the context of a claim that the board acted in bad faith when it approved the sale of the company, the relevant question is

whether the directors knowingly and completely failed to undertake their responsibilities to obtain the best sale price, not whether they did everything they arguably should have done to obtain the best sale price. An affirmative answer to this question requires more than a showing that the process may have been imperfect or flawed.

Applying these principles to the facts presented in *Lyondell*, the Supreme Court observed that the Lyondell board met several times to consider a premium offer, they were generally aware of the value of the company and they knew the chemical company market, they solicited and followed the advice of their financial and legal advisors, they attempted to negotiate a higher price, and they eventually approved the merger agreement because "it was simply too good not to pass along to the stockholders for their consideration." Based on these facts, the Supreme Court determined that the board had not breached its duty of loyalty by failing to act in good faith.

New Negotiation and Settlement Strategies

Since the beginning of the credit crisis, buyers and sellers have become acutely aware of the risk that circumstances may change prior to closing in a way that will make the transaction no longer attractive to the buyer. Both sides have recognized that it is important to negotiate up front to maximize leverage in that event.

Negotiating strategy will obviously depend on the perceived strength of one's economic position. As a general matter, in the current climate, buyers tend to have the upper hand due to the business challenges confronted by many companies and the absence of significant competition due to the caution of other buyers.

Buyers are seeking protection against changes between signing and closing by narrowing the scope of the exclusions to the concept of MAE and imposing specific conditions to closing tied to the state of the seller's business. For example, if it is important to a potential buyer that the seller retain a specific customer or customers or that the seller achieve its forecasted revenue projection, buyers are more prepared to walk away from the transaction rather than sign an agreement without these conditions and assume the risk that it be forced to close over these contingencies. In addition, prior to the credit crisis,

strategic buyers were often prepared to assume the risk that they could obtain financing for their transactions between signing and closing. In the current environment, they are increasingly unwilling to assume the risk that the financing contingency may not be satisfied. Accordingly, strategic buyers are beginning to negotiate for a limitation of their liability to a termination fee in the event that the financing contingency is not satisfied. For example, the merger agreement between Pfizer Inc. and Wyeth in January 2009 contained a financing condition that required Pfizer to pay liquidated damages of $4.5 billion as Wyeth's exclusive remedy if the merger failed to close because financing was not obtained. However, the financing condition could only be exercised if the financing did not occur because (i) Pfizer did not receive a specific credit rating taking into account the merger with Wyeth or (ii) Pfizer had suffered an MAE.

From the seller's perspective, it is more important than ever to ensure that the contracting party has the financial capacity to perform its obligations and that these are supported by commitments and guarantees of affiliated entities. Without these commitments, the failure of the buyer to effect certain actions may not constitute a breach of the merger agreement or, even if there is a breach, the contract may fail to provide any meaningful remedy if the contracting party is a shell entity. In private equity transactions, sellers are now much more likely to require that the private equity sponsor itself become a signatory to the merger agreement or, at a minimum, to provide specific guarantees. In addition, sellers are more focused on the precise terms of the buyer's debt commitments and may even negotiate for the right to be entitled to require the buyer to enforce the terms of the commitments against the bank.

If a dispute arises after an agreement is signed, the settlement strategy will depend on many variables, but most significantly the leverage afforded by the plain terms of the merger agreement and in particular whether the remedy of specific performance is available to the seller, and whether the liability of the buyer is capped or uncapped. Often it is not clear how the language of the merger agreement applies to the facts that have given rise to the dispute, and there may be ambiguity in the provisions of the merger agreement itself. If liability is uncapped, a buyer certainly has a strong incentive to reach a negotiated settlement, and rather than contest an uncertain litigation, the seller may conclude that settlement is its best remedy in view of the fact that protracted litigation may ultimately damage the business. In addition, sellers

have to be realistic in their assessment of what is possible for the buyer if there is doubt that financing can be secured under the terms contemplated when the original terms were agreed to. The parties may renegotiate a reduction in the price, perhaps in combination with a package of other concessions such as a rollover of a portion of the principal shareholders' equity into the surviving company. Alternatively, the parties may agree to terminate the agreement in exchange for payment of a termination fee and/or an equity contribution to the seller's business.

Changes in Structuring M&A Deals

The challenges presented by the economic environment have affected the way attorneys structure M&A deals. For example, we recently represented a privately owned strategic buyer in its purchase of a private company owned by its founder and members of his immediate family. Although due diligence had gone well, in light of the unwillingness of the buyer's traditional lenders to provide acquisition financing, the buyer did not believe it could obtain the additional debt financing that would be required to allow it to finance the purchase at a price acceptable to the seller. The buyer eventually made a proposal that effectively covered most of the financing gap between the seller's valuation expectation and the buyer's cash resources through additional cash payments tied to the achievement of the seller's financial projections over the two years following the closing. In addition, the buyer and seller agreed that the founder would roll over a small portion of his equity into the acquisition subsidiary subject to a buy-sell agreement that would allow the company to redeem and the seller to put that interest at fair market value at predetermined intervals in the future. In the past, a buyer of the client's standing would have been able to secure debt financing for the seller-financed portion of the deal, and competition for the seller's business would have made the buyer's earn-out and roll-over proposal an unattractive and unsuccessful proposition.

Strategies in 2010

Strategies in 2010 will likely see a continuation of trends that began to emerge during 2009. For example:

- Buyers will negotiate for a definition of MAE that specifically reflects the conditions that are fundamental to the buyer's rationale for the

transaction. The purpose of this change is to draft around what is now clearly, in light of the Chancery Court's discussion in the *Hexion* case, the default rule that, absent express language to the contrary, changes that do not affect the overall earnings potential of the seller in a durationally significant manner, will not excuse the buyer's performance under the contract. Buyers will be striving to maintain the maximum flexibility for exiting or renegotiating the terms of a transaction where any of the fundamental assumptions on which their expectations are based change materially after signing. For example, if the seller's short-term projections or specific customer relationship are an inducement to complete the transaction, the definition will provide that failure to meet the projections or the loss of the customer will constitute an MAE.

- Strategic buyers that require financing to complete the transaction will try to negotiate for a reverse termination fee that provides the seller's exclusive remedy in the event that financing is not obtained in a timely manner. This technique has migrated from private equity transactions and has already been employed in some large transactions in the pharmaceuticals industry.
- There is a general expectation that M&A transactions will be subject to increased scrutiny under the antitrust laws under the Obama Administration. To maximize certainty of closing, sellers will seek to negotiate that the buyer be committed to undertake the disposition of any assets or take other actions as may be required to secure clearance from the Federal Trade Commission under the antitrust laws. Alternatively, sellers may seek to negotiate for payment of a termination fee if the buyer is unable to secure antitrust approval on terms that are acceptable to the buyer.
- Prior to the credit crisis, many sellers entered into agreements with shell vehicles created by private equity fund sponsors that were formed specifically to complete a transaction but which relied for their funding on contributions from third-party debt and equity providers. The sellers relied on the private equity sponsor's concern to preserve its good reputation as a party that could be trusted to complete a transaction even though the sponsor itself was not obligated to complete the transaction (its liability for failure to close typically being capped at a low percentage of the transaction value). The number of broken deals precipitated by the current crisis will

make sellers reluctant to rely solely on the private equity sponsor's assurance concerning its reputation. It is expected that sellers will implement various strategies in an effort to limit the degree of optionality inherent in many earlier private equity-sponsored transactions to ensure that the transaction in fact closes. First, sellers will be more insistent that the private equity fund sponsor be a party to the acquisition agreements or, alternatively, that it guarantee the acquisition vehicle's obligations under the acquisition agreements. Second, sellers will seek to negotiate that all covenants material to the completion of the transaction are obligations of the private equity fund sponsor (directly or indirectly through a covenant of the contracting party to cause the fund to take certain actions). And thirdly, sellers will seek to negotiate a reverse termination fee that is substantially higher than fees in the range of 3 to 4 percent of the transaction value that were common prior to the credit crisis, and limit the range of circumstances in which the buyer can terminate the agreement by paying the reverse termination fee.

Major Hurdles in 2010

Different companies will face different hurdles in the upcoming year reflecting factors unique to their situation.

Liquidity Issues

For example, many fundamentally sound companies that may be facing a liquidity crisis in 2010 because of the general business conditions coupled with the continuing tight credit markets, which are making it difficult to refinance existing debt. Although the long-term outlook under normal conditions for these companies would have been good, there is concern regarding their viability in the short term due to these factors.

We will be assisting clients evaluate all their strategic alternatives. In the current environment, these will include the different types of distressed sales that may be feasible, such as a prepackaged bankruptcy as well as dispositions of existing businesses. We will be helping these clients understand the legal process and timeframes within which these strategies can be implemented.

Companies that may be in this position in 2010 should begin to evaluate their businesses in this context now so they are not taken by surprise and rushed into action under unpredictable circumstances in the future. For example, such companies should be examining all potential sources of liquidity, including new investors. They should also undertake a review of all material contracts to understand potential restrictions on the restructuring alternatives so they can be addressed proactively in advance.

Anti-Takeover Defenses

In recent years, many public companies have dismantled anti-takeover protections in response to pressure from shareholder activists and the influence of corporate governance rating organizations. For example, shareholder rights plans or poison pills have been redeemed or allowed to lapse, and staggered boards have been declassified. These developments have made these companies more vulnerable to opportunistic unsolicited takeovers.

We believe that in 2010 companies that survived the economic crisis in relatively strong condition will seek to exploit the opportunities created by the combination of an economic downturn and the absence of the traditional anti-takeover defenses. It is important that public companies that may be confronting this situation be able to articulate a long-term business strategy to their shareholders and how this will result in the creation of long-term shareholder value. The strategy and its implementation must be understood by the board of directors, continually reviewed, and explained to shareholders. Counsel can assist such companies in the particular messaging and communications with shareholders, as well as help create a legal record that establishes that any actions that may be taken by the board in response to an unsolicited approach are consistent with its fiduciary duties in support of its long-term strategy.

Counsel can review with the board the anti-takeover protections afforded by state statutes and explain the standards by which any actions taken in response to an unsolicited approach will be reviewed by the courts. Counsel should discuss with the board the feasibility of reinstituting anti-takeover protections and other actions that may be taken in response to specific threats in the future.

Evaluating Targets and Reducing Liabilities

Buyers will face the challenge of evaluating target companies against the background of a regulatory environment that may change significantly depending on the initiatives undertaken by the Obama Administration. For example, if the Federal Trade Commission subjects transactions to more thorough antitrust scrutiny, this is likely to result in more second requests under the Hart-Scott-Rodino Act and the potential for clearance to be conditioned on the parties' agreement to take specified actions that would minimize the threat to competition. Accordingly, buyers must factor into their deal planning, to a greater degree than in recent years, the possibility for substantial delays in securing clearance with the accompanying deal uncertainty created. To prepare for this new environment, buyers should consult with their antitrust counsel at an early stage in their acquisition planning process so that potential issues can be identified and addressed. Transactional lawyers can assist buyers in understanding how transaction risk can be allocated among the parties in response to potential challenges and demands by the Federal Trade Commission.

Initiatives in other areas may also increase the liabilities inherent in acquisitions. For example, more rigorous enforcement of or changes to existing laws may result in the imposition of significant penalties that were not anticipated or may affect a seller's business to such a degree that the assumptions for the acquisition are materially affected. Sellers often seek to exclude liabilities resulting from changes in laws after an acquisition from their indemnity obligation, and to exclude MAEs resulting from changes in laws after signing but prior to closing from the definition of MAE. Potential acquirers should consult with their counsel to understand the ramifications of pending legislative initiatives so that these can be taken into account in their transaction planning and negotiation.

New Service Offerings

One of the most active sectors of the M&A market in 2010 is expected to be acquisitions of distressed companies by healthier companies seeking to exploit opportunities to acquire assets at relatively low valuations. It is important that buyers understand the different structures that may be employed to acquire distressed assets and the risks attendant on such acquisitions under each structure.

There will likely be many opportunities for transactional lawyers in conjunction with their firm's bankruptcy and creditors' rights groups to assist companies in evaluating and structuring the acquisition of potential targets in distressed situations. This team would work closely with lawyers in specialized areas to help the client understand the risks assumed and how these can be mitigated in the context of different structures. For example, given the decline and volatility in the stock market, it will be important to evaluate the funding status of pension plans and any potential withdrawal liability that may be triggered by the transaction.

The Impact of a New Administration on M&A Law and Practice

The change in administrations did not have a discernible impact on the development of M&A law and practice in 2009, as the administration focused its attention on the economic problems and the condition of the banking industry. However, changes are widely anticipated in the future.

In particular, transactions are expected to be subjected to greater scrutiny under the antitrust laws for their potential anti-competitive effects in contrast to the more laissez-faire approach of the previous administration. As a result, we expect that parties will engage in more detailed negotiation concerning the covenants with respect to regulatory approvals, including most significantly which party should bear the risk and cost if the Federal Trade Commission decides to condition its clearance of the transaction upon dispositions of assets or other actions by the acquiring entity.

In general, practitioners are preparing for more rigorous enforcement of existing laws and regulations, as well as the adoption of new laws and regulations; for example, in the areas of environmental, employee, and consumer protection. These developments are likely to reinforce buyer caution and result in further extensive due diligence investigations. To the extent that such regulations materially increase the cost of doing business, they may depress valuations of target companies as the M&A market recovers.

To the extent that the federal government adopts laws or implements policies as a result of the credit crisis that directly or indirectly limit the amount of capital that can be dedicated to private equity and other debt-financed transaction structures, reform of the banking industry may affect

the amount of capital available for acquisition debt financing and delay a resurgence of M&A activity.

Changes in the tax laws that increase or otherwise adversely affect the taxation of partners in private equity fund limited partnerships may diminish the attractiveness of this form of investment vehicle in the future. Any reduction in the amount of capital from this source is likely to delay and/or reduce the extent of the recovery of the M&A market.

Conclusion

In response to the economic downturn, buyers have become more cautious and risk averse, and this conservatism is reflected in more extensive and extended due diligence and the risks they are prepared to assume. This phenomenon is likely to continue into 2010. The absence of competition for transactions reduces deal momentum, and these conditions have contributed to an extremely difficult environment to complete transactions.

In litigation resulting from a series of broken deals, the Delaware courts have been called on to define the meaning and scope of provisions that are material to the interpretation of transaction agreements. The principles articulated by the courts in the cases discussed above will influence the manner in which attorneys address these issues in acquisition agreements for the foreseeable future, regardless of the economic environment. For example, there will be greater focus on the details of the MAE clauses as buyers seek to expand the narrow ranges of circumstances that trigger a termination right under the Delaware courts' interpretation of the standard clause and its carve-outs.

The broken deals precipitated by the credit crisis will likely result in a refinement of the concept of the reverse termination fee. This mechanism was developed by private equity sponsors to limit their liability to an agreed amount if the sponsor's acquisition vehicle did not close the transaction under specified circumstances. The readiness of many buyers to exercise their termination rights has indicated to many practitioners that the reverse termination fees were too low and the range of circumstances in which they could be exercised was too broad. In the future, sellers can be expected to negotiate increased termination fees and narrow the range of circumstances

in which the termination rights can be exercised. At the same time, the concept may continue to migrate to transactions involving strategic acquirers, as it provides a simple mechanism by which parties can allocate the risk of contingencies in an environment where a particular outcome is uncertain (e.g., financing, antitrust, and other regulatory approvals).

It is impossible to predict how deal terms will evolve in response to these developments. All that can be said with certainty is that practitioners must continue to be prepared to negotiate with flexibility even with respect to terms that, several years ago, were established deal precedent. The next twelve to twenty-four months are likely to be characterized by greater variety in transaction terms as lawyers draft agreements that address the needs of their clients in the challenging and changing environment.

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During the past fifteen years, Mr. De Rosa has counseled buyers and sellers of businesses by means of merger, tender offer, share exchange, and asset purchase, including the acquisition of public companies by means of cash tender offer and stock merger. He has also counseled issuers of notes and other securities in private-placement transactions with large institutional investors. He has substantial experience advising public companies with respect to their reporting and disclosure obligations under the federal securities laws and corporate governance matters.

M&A in the Transitional Period

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Recent Trends in M&A Transactions

The economic and political situations in the United States, and to some extent, around the world, have had a profound impact on U.S. merger and acquisition (M&A) transactions in 2009. Every industry, every sector has had to contend with a reduction in available cash and credit, both of which had previously been relatively plentiful. Revenues declined, the public markets were unavailable, traditional commercial lending slowed to a glacial pace, and venture capital and private equity firms sat on the sidelines and reconsidered their investment strategies. Additionally, the political climate has changed—health care as a business is likely to undergo changes in regulation, which could have a profound impact on business models and valuations, and there is a renewed interest in alternative energy sources, both renewable and traditional non-fossil fuel-based. Most people expect the U.S. and global economies to improve in 2010 and beyond. Also in 2010, we are likely to gain some insight into the direction health care in the United States will head and what the appetite is both economically and politically for a sustained interest in alternative energy sources. That makes 2009 a transition year. Transition periods are traditionally very difficult, as they are rife with fact patterns that did not occur previously and are unlikely to recur once the transition has ended. That said, the 2009 judicial decisions are likely to have far-reaching effects on how M&A transactions are structured and drafted in the future.

The economic and political factors in 2009 alone changed many aspects of M&A transactions, affecting not only how buying and selling of companies occurred, but whether transactions occurred at all. Many business owners—individual, institutional, and corporate—who had previously considered selling their companies suddenly faced a significant drop in valuation caused by general economic factors that exacerbated any reduction in value related to company- and industry-specific issues. These lower valuations lead to a market in which strategic sales and profit-taking all but disappeared and each business for sale was presumed to be distressed. This presumption, in turn, lowered valuations even further and reduced the number and range of parties interested in a potential transaction.

Relative leverage and mutual self-interest drive how a buyer and seller choose to structure and price a deal. Deals with similar price tags but substantially different structures can have quite different values to the

buyers and sellers. For instance, there are three methods of limiting liabilities assumed by a buyer: (i) purchasing assets that have been through some type of bankruptcy process, (ii) purchasing assets outside of any bankruptcy context, and (iii) purchasing or obtaining stock (via stock purchase or merger) and adding contractual limitations and indemnities. On the surface, what is purchased looks the same: the buyer accepts certain assets and rejects all or certain liabilities. However, the effect of the different structures can vary widely. As a general rule, a buyer who purchases assets rather than stock is able to "cherry pick" the assets it wants and leave ownership of unwanted assets and liabilities with the seller, while a buyer who purchases stock must take the entire business and can limit any assumed liabilities only through contractual provisions such as indemnities or commercial products such as insurance policies. The structures can also affect price. Buyers typically adjust the purchase price downward as risk increases; therefore, it is relatively common for an asset purchase to price slightly higher than a stock transaction. Tax considerations also play a major factor in pricing a transaction, with a tax-favorable structure pricing higher than a structure that is less favorable to the buyer.

Assets that have been "cleansed" through some type of bankruptcy process are, absent some type of fraud, delivered to the purchaser free and clear of all liens that may have previously attached to such assets, and a buyer can take comfort in the certainty of the process. In previous years, only assets that were considered "toxic" were expected to go through such a process. Because so many transactions in 2009 were presumed to be distressed, this type of asset purchase increased significantly during that period. Assets that buyers purchase directly from the sellers outside of the bankruptcy process could be less protected from creditor claims, but were still fairly prevalent in 2009. The least popular structure during this period of uncertainty is the stock purchase or merger. In that type of transaction, the buyer receives, whether it wants them or not, all of the assets and liabilities of the company. To limit liability in a stock transaction, the buyer typically requires an indemnification from the seller (or the selling stockholders). Indemnification provisions are highly negotiated, carefully drafted, relatively expensive, and only as good as the amount of money in the seller's pocket at the time of enforcement. One way of mitigating the risk of indemnities was to purchase an insurance policy and transferring some of that risk to an insurer. The widespread economic instability prevalent in 2009 made

indemnifications questionable as a useful means of limiting liability, and the uncertainty facing many of the financial institutions, including insurers selling products like indemnification insurance, gave buyers and sellers less confidence in provisions that previously made sense. Therefore, contract provisions that had all but disappeared in the years of economic prosperity have made a comeback. One of these is the escrow structure in which a portion of the purchase price is retained by an escrow agent and dispensed after the risk of certain liabilities has passed. A second is the "seller paper" where the seller essentially becomes the lender to the buyer and finances a portion of its own sale price. Another is called an "earn-out," where the buyer holds back a portion of the purchase price and pays it to the seller if and when certain milestones have been achieved. For instance, if a buyer wants to reduce the risk that the sales projections of the seller are not achieved, it might include a term that provides for 30 percent of the purchase price to be paid after year one or two if sales have met or exceeded a particular target. There are also "claw-backs," meaning that concessions given to sellers or buyers are reduced or disappear if certain milestones are or are not hit. An example of this might be that a seller who is holding a note from the buyer for a portion of the purchase price might have to forgive all or a portion of the note if the company does not meet EBITA targets the seller projected for a particular period.

As banks limited or eliminated transactional financing products in 2009 and significantly changed lending ratios, the number of bank-financed leveraged buyouts dropped dramatically. This means that the number of transactions also dropped and valuations were reduced. Some buyers did not have the available cash to purchase target businesses, and some buyers made the determination that the transaction, even at a much lower valuation, no longer made sense financially. As the amount of debt in a transaction decreases, the amount of equity necessarily has to go up. As the amount of equity increases, the profits to the equity investor typically go down. This downward pressure on profits put downward pressure on valuations because equity investors will only invest if they can project a certain profit for the investment. The reduction in valuation caused sellers who did not have to sell their businesses immediately to pull out of the market and wait for valuations to increase. The debt-to-equity investment ratios likewise caused many buyers to want only high-quality, less risky businesses. The resulting mismatch of sellers and buyers in the marketplace meant that

fewer transactions were likely to occur. Again, we saw that necessity is the mother of invention (or reinvention). Equity investors with sufficient cash on hand could make (and some did make) investments with a high equity component, believing they could effect a leveraged dividend when the debt markets returned. However, these equity investors still had to consider, predict in their modeling, and explain to their limited partners at the annual meeting, when the debt markets would return and what terms would be available upon such return. Again, this uncertainty often caused equity investors to reduce their risk tolerance and kept them out of a market rife with questionable investment targets.

Advising Clients in M&A Deals

Our M&A clients rely on us to help them understand the current M&A landscape as well as the particular aspects of their pending transaction. M&A is generally market-driven from both a business perspective and a legal perspective. The buyer and seller decide to buy and sell based on market conditions in their respective industries. The banks and other lenders decide whether and how much to lend for the transaction based on market conditions in the financial industry. The transaction is structured and negotiated in the context of market conditions in the M&A industry. The buyer and seller each engage a number of advisers to assist them in determining how best to negotiate the different markets, including business consultants, investment bankers, accountants, and lawyers. There are general parameters for M&A deals, but each deal has unique aspects that cause it to "act" in a different way than other deals that might look very similar. Whether or not the buyer and seller are involved in regulated industries, what the tax implications are, how fast the transaction needs to occur, how the purchase price is determined and what type of consideration is involved, who has to approve the transaction, the experience of the management team, and their relationship with the board and shareholders are all factors that can affect how smoothly or poorly a transaction progresses. Our job as legal advisers to our M&A clients is to understand what they want to accomplish both with the transaction and within the transaction, and to help them achieve those goals while minimizing the associated risks, both business and legal.

Leverage is a word that describes the relative power of the parties to a negotiation. In markets like the 2009 M&A market, the leverage in the

purchase is weighted heavily in favor of the buyer, but the leverage in the financing of the transaction is weighted heavily in favor of the lender. The seller's leverage in this situation comes from the value of its business to the buyer, the ability of the seller to withstand a protracted negotiation, its understanding of the market (both in its industry and in the M&A market), and its ability to fully comprehend the terms of the transaction documents. It is absolutely true that in these situations, knowledge is power and that assumption gets people in trouble. The more a party knows about the transaction documents and why they say what they say, the more appropriately it can negotiate a transaction. For instance, although the parties may appear to be treated equally by the wording of a provision such as indemnification, if one party is significantly better financed than the other is, the burden may disproportionately affect the less well financed party.

Timing is another element of a transaction that can create a significant amount of leverage or destroy leverage that has been created by other elements. If a party is in a hurry, that party loses leverage; however, waiting also poses risks. In a busy M&A market, delaying a transaction can cause the loss of the target to a competitor, and in a market like the 2009 market, a delayed transaction can mean that the target could lose too much value to be attractive or go out of business. For the most part, there is a point at which a target becomes uninteresting because its financial situation is too dire to recover without too much capital being infused. Clearly, a buyer wants to acquire the target close to that bottom point so that they can maximize their upside on the recovery.

Changing M&A Legal Strategies in 2010

The business side of the M&A landscape will change as quickly or slowly as the factors that influence it. All signs point to 2010 being a year of many changes. Two factors will have significant influence over how transactions occur in the next phase of the transition: the availability of exits and the manner in which companies have conducted themselves through the downturn. The private investment model is based on money flowing through the system. There are asset classes into which money is invested with investment professionals typically allocating certain percentages of their investments into particular asset classes. Investments into funds that

conduct buyouts or invest in privately held companies are currently over their allocations because of the lack of exits in the industry over the past two years. If there is no money flowing out of the system, which there currently is not, then new money cannot flow into the system, making it more difficult for new deals to get done. A second factor relates to the quality of the targets on the market. The phrase "Desperate times call for desperate measures" has been uttered regularly throughout boardrooms over the past two years. Management teams have done their best to survive during the downturn. Now that the economy looks like it is beginning to recover, those measures will be evaluated. The extent and creativity of the desperate measures will have a tremendous impact on whether and how a potential target becomes an acquisition.

For these and other reasons, investors are likely to be more deliberate in all aspects of a transaction. The feeding frenzy associated with the peak of the M&A market has ended for now and the acquirers are taking more time to evaluate and perform due diligence on potential targets. They find themselves in a situation where they have to deploy more equity capital to get a transaction done, and as more of their capital is at risk at a potentially lower profit margin, they will likely undertake additional due diligence to avoid unnecessarily lowering that margin further. Additionally, boards, shareholders, and management teams have done what they felt was necessary to keep their companies alive through the downturn. Acquirers will be looking to manage their risks more carefully because of the shrinking profits associated with less leverage, so they will be looking for reasons to lower valuations. This creates a bias in favor of the buyer even in a recovering market. It also means that many deals that get started will not close and deals that actually do close will take longer and will be more expensive both for the target and for the acquirer. The transaction terms will also continue to move in the direction of seller financing, escrowed purchase amounts, and associated indemnifications, as buyers want sellers to continue to have skin in the game while the company transitions from its previous ownership.

Recent Decisions Impacting the Future Scope of M&A Law

The most recent important court decisions affecting M&A transactions relate to differing areas of the M&A landscape, but all have implications

when negotiating a transaction. The first, *Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008), addressed two issues: (i) whether a material adverse effect had occurred in the context of the financial meltdown that was occurring in 2008, and (ii) the standard for a knowing and intentional breach of an agreement. In the *Hexion* decision, the Delaware court parsed the definition of material adverse effect, which contained an exception for industry-specific woes other than those that affected the target disproportionately, and determined that the carve-out could not be reverse-engineered to create a material adverse effect. Vice Chancellor Lamb states notably "it is not a coincidence" that "Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement." In light of this statement, it is interesting to note that the definition of material adverse effect is heavily negotiated in every M&A transaction. Also in that decision, Vice Chancellor Lamb ruled that a knowing and intentional breach did not require that the breaching party knowingly and intentionally breach the agreement, only that it deliberately act in a manner that breached the agreement. This means the breach itself does not have to be intentional, only the action that caused the breach.

Lyondell Chemical Co. v. Ryan, 970 A.2d 235 (Del. 2009), was another notable decision in 2009. In this opinion, the Delaware Supreme Court reversed a Court of Chancery decision in its determination of when a board is required to take affirmative action to maximize the value to the shareholders in a potential sale. The Supreme Court made it clear that a board's *Revlon* duties (the obligation to obtain the best price for the shareholders in a sale of the company) do not attach until the company is "in play," further defining "in play" as the time the company has engaged in a sale process or a transaction is inevitable. This case presented a very narrow set of facts, but is important in the sense that it suggests some parameters to a board's responsibilities when an unsolicited offer is received. The target company was in a very specialized industry in which there were few players, and it was being actively courted by a potential acquirer that was also pursuing one of its rivals, Huntsman Corp. When Huntsman announced a transaction with Hexion, the Lyondell board was asked to commit to the failed acquirer of Huntsman, which, given the lack of other players in the industry, the size of the purchase price, and the terms of the transaction, the board felt it had to do. This decision makes it clear that each board must consider the set of

circumstances in which it finds itself when a bidder appears. It is a pragmatic approach. However, the court made it clear in *Police & Fire Retirement Sys. of the City of Detroit v. Bernal, et al.*, 2009 WL 1873144 (Del. Ch. 2009), that where there is more than one bidder, the board has to take a more proactive approach and must be very careful not to favor one bidder over another by granting contract provisions that preclude the other transaction from being competitive.

Two other cases that are not surprising, but which should serve as a warning to targets and their counsel as they negotiate with shell company purchasers, are *Alliance Data Systems Corp. v. Blackstone Capital Partners V L.P.*, 963 A.2d 746 (Del. Ch. 2009), aff'd, 976 A.2d 170 (Del. 2009), and *James Cable LLC v. Millennium Digital Media Systems L.L.C.* 2009 WL 1638634 (Del. Ch. 2009). In these cases, private equity fund acquirers set up shell acquisition companies to purchase the respective targets. This is standard procedure in a private equity buyout context, as the funds prefer to hold their portfolio companies as subsidiaries rather than as divisions for obvious reasons. These cases arose because the private equity funds (i) were not contractually required to and (ii) chose not to put the assets of the private equity fund on the line to ensure approval or financing of the transactions. The transactions did not go forward, and the target sued for the break-up fee alleging breach. Because the private equity firms were not contractually obligated to perform as the target companies claimed they should have, the court found that no breach had occurred and no damages were owed. As a general rule (to which there are always exceptions), from a practical, business perspective, it makes no sense for a multibillion-dollar private equity fund to guarantee anything but performance of the subsidiary and certain financial pieces, subject to the participation of the remaining players in the transaction. Private equity funds use a very carefully constructed funding balance sheet to maximize their profits and minimize their risks in a transaction, and can have hundreds of portfolio companies. Contractually obligating the fund to use its assets or influence often does not make sense and could breach the fiduciary duty of the fund principals to its limited partners, so the funds very carefully limit their contractual exposure in each purchase. These cases do serve as a warning to targets to remember the nature of the purchaser and to make no assumptions about what they can enforce outside of the agreement. It may not change the outcome of the negotiations, but understanding the risk is a big step toward mitigating losses.

Collectively, these decisions have provided steady guidance in troubled times and signaled a slight pragmatic shift in the M&A context. The *Lyondell* line of cases refocuses the analysis of the Delaware courts on the process and actions of the board rather than the outcome to the shareholders, which will provide long-awaited relief to target boards. The *Hexion* case allows targets a slightly wider set of possibilities in pleading breach if they have been left at the altar by deliberate acts prohibited by the contract, while the *Alliance Data* line of cases reins in the idea that assuming material terms is acceptable in contract law.

The Other Perspectives on M&As

Any discussion of M&A in troubled times would not be complete without a brief analysis of the effects of the times on the boards, shareholders, and lenders. As discussed previously, the process has lengthened—what might have taken ninety days in 2006 could take six months or more in 2010. From the perspective of the target, it takes longer to engage potential acquirers in the process and then it takes longer to conclude the process. The more time between the beginning and end of a negotiation or transaction, the greater the risk that the transaction will not occur. The buyer could suffer some kind of financial or industry problem, the financing for the transaction may not be approved, there may be new regulatory overlays that make the transaction less attractive to one or both parties, or the due diligence may be conducted at a level that causes the negotiations to sour. This uncertainty means the board must also keep its eye on other options at all times—just in case. We do appear to be exiting the phase where combinations were for survival purposes rather than for growth, which means the "need" dynamic is starting to change.

Shareholder discontent and fatigue is also an issue; when a company considers an acquisition or sale in the current marketplace, the board must carefully consider how the shareholders might react. In addition to the duty to maximize the value of the company for the shareholders, the board and management teams also have the practical issue of maintaining public relations with the shareholders to avoid misunderstandings about what the board and management team are planning and why, especially in companies that are thinly traded, whose stock price has dropped significantly, those in which institutions have large holdings, or those that have investors and

employees whose dreams of liquidity have been crushed by the evergreen promise to go public but for the lack of a public market. We see a significant amount of shareholder and board fatigue with the status quo and the number of transactions that almost happened, as well as discord between business partners, boards and management teams, members of management, and the like. For instance, take a company that has been looking to find a buyer or become a buyer for the past two years and every potential transaction has been thwarted by financing woes or indecision on the part of the other party or a failure to come to terms (typically on valuation or a related issue). The company may be foundering because of a lack of direction, the management doesn't really know which way to go, the board doesn't have better ideas, and the stockholders want out. All of the interests compete with each other, and there is no clear solution. Investors thought they were in the company for a limited period of time and something was just on the horizon that would provide some liquidity. There may be new investors who came in to "rescue" the company, but whose interests are not aligned with the legacy shareholders because the economic terms of the investment are different. Whatever the scenario, the current state of things means that companies are often, from a practical perspective, litigating the deal documents before executing them. This means each transaction undertaken with these kinds of facts is essentially a hostile transaction, which takes more time, becomes more expensive, and often the negotiation process itself is less useful than in a typical situation, because the parties often feel like they have to negotiate for the least common denominator. They have to worry about the 3 percent shareholder who can hold up the entire transaction or the rogue board member or the creditor that is in trouble and is looking to the company to help solve its problems. Essentially, the focus shifts to non-core issues and the deal can take a turn into the twilight zone if people aren't careful and properly advised. Often in these situations, the board has to make a determination as to whether to launch a "win the hearts and minds" campaign, or whether to simply say "We are in charge, and you can sue us later."

Upcoming Hurdles for Clients in M&A Deals: More of the Same

The two main impediments for M&A deals are lack of debt financing and uncertainty of exit. A properly structured acquisition balance sheet means buyers are more inclined to say yes because the profits are less risky. In the

boom years of the M&A market, debt was so inexpensive that equity investors did not suffer "sufficient" pain for making bad decisions. In the corrective period (which we are in now), the equity investors will very likely have to shoulder more of the risk and share more of the profit in order to get a sufficient amount of debt on the balance sheet. Because traditional lenders are pulling back, the mezzanine finance investors are stepping in to fill the void—at a much higher price, of course. Mezzanine finance fits in between the preferred stock and the senior debt. It typically has higher interest rates, is shorter-term, can be secured or unsecured, and probably requires some kind of equity kicker. It is still less expensive than pure equity but is significantly more expensive than the senior debt that equity investors were able to secure in the boom years.

Just as every company was going to have an initial public offering in the late 1990s, every company was going to be acquired by a private equity fund in the 2000s. Starting in mid-to-late 2010, there will likely be a more balanced approach to exit. Some companies will have initial public offerings, some will sell to strategics, some will combine and grow, and some will be purchased by private equity funds. If the past is any indication of what the future holds, the pricing is likely to be best with strategics and initial public offerings.

M&A Deals in a New Administration

Two areas businesspeople are watching closely these days because of the change in administrations are taxes and health care regulations. As health care reform is looking like it won't significantly change the business model for these companies, we will likely see additional investment by pharmaceutical companies and forward movement with health care information technology companies. Biotechnology is still critical and still underfunded in its early stages, which doesn't look like it will change with the new administration.

Taxes are another unknown factor in this environment, although there appears to be a fairly consistent belief that they will be higher. If the carried interest gets taxed as ordinary income, it may drive some of the investment professionals into other businesses. This, while being a very unpleasant and unwelcome result for those people for whom investments just became

significantly less profitable, may have the unintended consequence of providing a lot of brainpower and creativity to sectors that previously had not benefited from that kind of resource. The more taxes increase, the more likely transactions will be structured to take advantage of any tax benefits available.

The most significant changes we are likely to see with the new administration are both political and economic and relate to science and technology education as well as taking seriously the ability of energy resources that are not fossil fuel-driven to affect in a positive way our strategic relationships and national security on a global scale. Alternative energy reaches into a number of areas, and therefore we are likely to see some very committed people working in the alternative energy space. A word of caution, however, is due here. This commitment to alternative energy resources is ripe to be the next investment fad. The industry is sufficiently advanced and specialized that people who really understand how these technologies have been developed over the past forty or more years are critical to making sound investments. It is past the point of throwing things up against a wall to see what sticks. This is important to know because if too many investors jump into the industry without understanding the true value of the technologies being developed, the alternative energy industry is likely to experience an unsupportable rise in valuations, causing serious, industry-savvy, long-term investors to exit the market and wait until valuations make sense for them. This would create significant unwelcome delays in getting these products to market.

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The Need for Carefully Tailored M&A Strategies in an Economic Downturn

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ASPATORE

Material Developments in M&A Law and Trends to Look for in the Near Future

Given the global financial meltdown that began in 2008, the deal climate in 2009 was markedly different from in prior years, despite the recovery that gained steam over the summer. While credit markets are improving, the markets have not thawed completely and the terms to obtain credit (whether from commercial banks or from private equity investors) remain stringent. Because of these macroeconomic changes, deal lawyers have become more creative in structuring acquisitions. This chapter looks at some of the material and recent changes in mergers and acquisitions (M&A) law and trends to look for in the near future. For example, earn-out structures (using a variety of metrics such as working capital, earnings, and debt levels) have become more prevalent, and this trend is expected to continue. Looking ahead and given the difficult economic environment, transactions in an insolvency setting will pose special challenges in terms of corporate governance and deal structure.

As discussed below, significant case law developments have altered the deal landscape. For example, in the wake of *Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008), which is discussed below, material adverse effect qualifiers are being drafted in a much more specific manner with regard to general economic and industry-specific changes. Similarly, much more focus has been placed on defining the respective obligations of the parties to an acquisition agreement and clarifying what "reasonable efforts" require of them.

The common thread in M&A deals is risk allocation—this has not changed. Both buyers and sellers are acting cautiously—sellers require deal certainty, and buyers need assurances that the target will not suffer material adverse changes—which we believe is a positive development. Further, to the extent that the *Hexion* decision requires ongoing communications between the parties to avoid a breach of the agreement due to the unilateral action of one party, the purchaser and seller have encouragement to work together to resolve issues and ultimately consummate the transaction, as opposed to subsequently litigating its collapse.

Notwithstanding the changes described above, our overall strategy in the acquisition environment has not changed—that is, to assist senior

management and board members in evaluating the transaction, and negotiating and drafting a deal as specifically as possible, taking into consideration potential macroeconomic and industry-specific changes that may be unforeseen at the initial stages of deal evaluation. It is only the mechanisms by which we seek to achieve the goals of our corporate clients that have been revised. The particular changes we have previously made and are in the process of implementing are discussed below.

Key Cases in M&A Law

In our opinion, the following recent cases have had the most significant impact on M&A law for the reasons set forth below:

Impact of Huntsman v. Hexion

Communication

As discussed below, when Hexion became concerned about the potential solvency of the target company, it unilaterally took actions that severely hampered the likelihood that the deal could be financed. However, under the terms of the merger agreement, Hexion was required to undertake its "reasonable best efforts" to obtain financing. Therefore, *Hexion* is extremely relevant for its specific examination of the "reasonable best efforts" standard.

In *Hexion*, Hexion Specialty Chemicals, and its ultimate controlling shareholder, Apollo Global Management, entered into a merger agreement with Huntsman Corporation, the target company, that had no financing contingency and no condition precedent that the merged companies be solvent following the merger. Id. at 721. Hexion was required to use its "reasonable best efforts" to obtain financing. Id. at 724. However, once Hexion became aware that, due to negative financial quarterly results by Huntsman, it was possible that the merged companies might be technically insolvent, instead of discussing the issue with Huntsman, it had its own financial consultants issue an "insolvency opinion," which it then sent to the banks that had provided a commitment to provide financing, published the opinion abroad, and then filed a lawsuit for a declaratory judgment excusing it from performance of the merger agreement. Id. at 726–730.

Hexion relied upon a provision allowing it to terminate in the event of a "company material adverse effect" (discussed below). Id.

In response to Hexion's request for declaratory judgment indicating it had no further contractual obligations to Huntsman, the court instead held that "to the extent that an act was both commercially reasonable and advisable to enhance the likelihood of consummation of the financing, the onus was on Hexion to take that act. To the extent that Hexion deliberately chose not to act, but instead pursued another path designed to *avoid* the consummation of the financing, Hexion knowingly and intentionally breached this covenant." Id. at 749 (emphasis in original). The court held that a "reasonable response" to the fears of potential insolvency would have been for Hexion to "approach Huntsman's management to discuss the issue and potential resolutions of it." Id. at 750. Instead, Hexion expressly barred its financial consultants from communicating with Huntsman to request further information while drafting the insolvency opinion. Id. at 730. While Hexion's failure to discuss the issue with Huntsman's management immediately after the concerns about solvency arose was considered a potential breach, the court indicated that after the "insolvency opinion" was obtained by Hexion, "Hexion had an absolute obligation to notify Huntsman of this concern." Id. at 750. Its failure *alone* to discuss the potential issues with Huntsman "would be sufficient to find that Hexion had knowingly and intentionally breached its covenants under the merger agreement." Id. at 750–751. By proceeding to deliberately scuttle the financing by sharing its insolvency opinion and filing the lawsuit, Hexion merely compounded the existing breach. Id. at 751.

Therefore, Hexion's failure to approach Huntsman's management to explain its concerns and develop an appropriate course of action resulted in the court's conclusion that Hexion knowingly and intentionally breached its covenants in the merger agreement. The lesson to be learned is that when problems arise in a deal, it is crucial to communicate them to the other party and attempt to negotiate a solution to the extent feasible. In fact, it is an absolute obligation where the problems could potentially threaten the transaction. Thus, in most situations, we would avoid advising clients to take unilateral action in the face of changed circumstances.

Material Adverse Effect

As in many acquisition agreements, the merger agreement in *Hexion* specifically disclaimed any representation or warranty with respect to prospects, forecasts, or other future events. Id. at 741. In light of this type of provision, the court utilized a long-term perspective regarding earning power to determine if there was a material adverse change in the target's business and concluded that there had been no long-term impact on the target's business. Id. at 742–743. In reaching this conclusion, the court pointed out that the buyer could have asked for a warranty of short-term forecasts or a lower purchase price with some type of earn-out component. Id. at 741. From the buyer's perspective, deal lawyers should consider these types of provisions if important to the buyer's financial model.

Based upon market conditions, we believe the definition of a "material adverse effect" that entitles a purchaser to terminate the agreement needs to be more detailed, because, as in *Hexion*, a purchaser may try to end a transaction based primarily upon market conditions, as opposed to a condition that is unique to the target company and specifically tailored to a transaction. The *Hexion* material adverse effect provision expressly carved out general market conditions as follows: "in no event shall any of the following constitute a Company Material Adverse Effect: (A) any occurrence, condition, change, event or effect resulting from or relating to changes in general economic or financial market conditions... (B) any occurrence, condition, change, event or effect that affects the chemical industry generally..." Id. at 736–737. We subsequently discuss a provision we recently utilized regarding "material adverse effect," and believe that, in the current unsettled conditions, it is essential to carefully articulate what constitutes a material adverse effect, both for the seller and for the buyer.

Walk Rights

As previously discussed, the merger agreement at issue in *Hexion* did not contain a financing contingency (other than a covenant to use reasonable best efforts to obtain financing) or a solvency requirement. Id. at 721. Instead, the merger agreement contained a provision stating that if Hexion failed to acquire financing (or breached the agreement in various other specified ways), it would be subject to a $325 million liquidated damages

provision. Id. at 724. Going forward, great care should be taken in negotiating these types of provisions. While sellers may push back and require "best efforts" standards with regard to the buyer's performance obligations (as opposed to "commercially reasonable standards"), buyers should explore different financial models from the onset to determine the parameters of price adjustments if certain metrics are not satisfied, particularly if it is anticipated that the transaction will not be consummated shortly after the execution of the acquisition agreement (allowing more time for a material change in the circumstances surrounding the transaction). By failing to provide for a financing contingency and similar termination rights, Hexion put itself in an untenable position.

Burden of Proof

Another important issue in *Hexion* was which party had the burden to prove the occurrence of a material adverse effect. The court held that "absent clear language to the contrary, the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract." Id. at 739. It further notes that "commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement." Id. at 738. A "short-term hiccup in earnings" is insufficient to constitute a material adverse effect; instead, "poor earnings results must be expected to persist significantly into the future." Id. Consequently, it is clear that inserting a termination right based solely on a material adverse effect is not a wise drafting decision, as courts construe such a right very narrowly. Any event that would significantly endanger the consummation of the transaction should be addressed in the merger agreement expressly and be associated with a specific termination right.

Impact of Lyondell v. Ryan

In *Lyondell Chemical Company v. Ryan*, 970 A.2d 235 (Del. 2009), shareholders challenged a cash merger on the ground that the board of directors breached their fiduciary duty of loyalty by not obtaining the best sale price as required by a long line of Delaware cases beginning with *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (Del. 1986). Id. at 239. When the buyer filed a Securities and Exchange Commission form

indicating its intent to purchase a block of the stock of the target company (Lyondell Chemical Company), after recognizing that the company was "in play," the board of directors of Lyondell had a special meeting and decided to take a "wait and see" approach to the proposed acquisition. Id. at 237. After subsequent negotiations between the management of the target and the acquirer, Basell AF, the board of directors met again for an hour, indicated interest, and retained Deutsche Bank as its financial adviser. Id. Subsequently, the board met yet again, requested a higher price, a go-shop provision, and a smaller break-up fee. Id. at 238. Although the acquirer reduced the break-up fee, it did not raise the price or otherwise agree to negotiate the go-shop provision or its announced schedule for the acquisition. Id. After a presentation by its financial advisers opining that the price was fair, the board voted in favor of the acquisition and recommended it to shareholders, the vast majority of whom approved the deal. Id. at 238–239. However, some shareholders challenged whether the board had considered the transaction sufficiently to obtain the best sales price in accordance with its fiduciary duties. Id. at 239.

It is noteworthy that only the duty of loyalty was at issue in this case, as the bylaws of the target company protected the directors from personal liability with regard to breaching the duty of care. Id. at 239. With regard to the enumerated *Revlon* duties for the duty of loyalty, the Supreme Court of Delaware held that these duties do not apply simply when a company is "in play." Id. at 242. Rather, the *Revlon* duties apply only when a company receives an unsolicited offer or seeks a transaction on its own accord. Id. Consequently, the court concluded that the board did not breach its duty of loyalty because *Revlon* did not apply at the time that the Securities and Exchange Commission filing was made and only the business judgment standard applied to the "wait and see" approach taken at that time, which was met. Id.

In reaching this holding, the court looked at whether the board failed to act in good faith, which turned on whether the board members "intentionally disregarded their duties." Id. at 243. Since the board members did not knowingly and completely fail to undertake their responsibilities, they did not breach their duty of loyalty. Id. at 244. The court noted, however, that due to the directors' failure to conduct an auction or market check, and lack of "impeccable knowledge of the market," had the duty of care been at

issue, the directors might not have fulfilled this enhanced fiduciary duty of care by their conduct. Id. at 253. Specifically, "the directors apparently took no action to prepare for a possible acquisition proposal. The merger was negotiated and finalized in less than one week, during which time the directors met for a total of only seven hours to consider the matter. The directors did not seriously press [the purchaser] for a better price, nor did they conduct even a limited market check." Id. at 241.

From a corporate governance perspective, *Lyondell* provides guidance to board members in exercising both their duties of care and loyalty. Counsel should assist board members in developing a record to support the board's business judgment, ensure that an orderly sales process is conducted, and ensure that decisions are made in an informed manner. Further, the duty of care may require more than a "wait and see" attitude to a possible acquisition, and the board should, upon receiving signals that an acquisition may be imminent, develop strategies to approach the same.

Impact of Alliance Data Systems v. Blackstone

In *Alliance Data Systems Corp. v. Blackstone Capital Partners V L.P.*, 963 A.2d 746 (Del. Ch. 2009), *aff'd*, 976 A.2d 170 (Del. 2009), Aladdin Solutions Inc. (controlled by Blackstone Capital Partners V LP, in turn controlled by Blackstone Group LP, a large private equity group), and its wholly owned subsidiary, Aladdin Merger Sub. Inc., agreed to acquire Alliance Data Systems, which owned World Financial Network National Bank, a credit card bank. Id. at 749. Under the merger agreement, a condition of closing required regulatory approval from the Office of the Comptroller of the Currency (OCC). Id. Specifically, the agreement contained "a promise by Aladdin to use Aladdin's reasonable best efforts to get OCC approval; a promise by Aladdin to keep Blackstone from preventing the completion of the Merger; and a representation by Aladdin that it had the power to fulfill its commitments under the Merger Agreement." Id. at 750. This approval was not obtained, however, since Blackstone, in its capacity as the ultimate parent of the buyer, would not agree to guarantee certain financial obligations of World Financial Network National Bank. Id. at 749. The target company brought a lawsuit against the buyer on the ground that it breached the merger agreement by not causing Blackstone to agree to the conditions of the OCC. Id. at 750. The Delaware Chancery Division

disagreed. In reaching this result, the court reasoned that the agreement should have specified the requirements to be imposed on Blackstone in order for the buyer to be held responsible for that entity's actions. Accordingly, care should be given to tailor both affirmative and negative covenants to the exact understanding and agreement of the parties. Clearly, the importance of *Alliance Data Systems* is effectively that significant attention must be paid to drafting, both as to whether an affirmative covenant or a negative covenant is given, but also as to which entities are responsible for performing these covenants.

We further note the existence of a subsequent decision following the precedent set in *United Rentals Inc. v. RAM Holdings Inc.*, 937 A.2d 810 (Del. Ch. 2007). In *United Rentals*, United Rentals Inc. entered into a merger agreement with RAM Holdings Inc. and RAM Acquisition Corp., which were controlled by Cerberus Capital Management, also a private equity group. Id. at 813–814. Like the Aladdin entities in *Alliance Data Systems*, "RAM Holdings and RAM Acquisition are shell entities with *de minimis* assets that were formed solely to effectuate transactions contemplated under the Merger Agreement." Id. at 814. Cerberus was not a party to the merger agreement, but its investment fund, Cerberus Partners LP, merely executed a limited guarantee of payment obligations of the RAM entities for up to $100 million and Cerberus itself was identified as an "equity sponsor" in an equity commitment letter, agreeing to purchase the shares of RAM Holdings stock to finance the merger consideration under certain circumstances. Id. at 814–815. The merger agreement (i) allowed RAM to terminate the merger in the event of a material adverse change in the business of United Rentals specifically, but not based on national credit markets; (ii) contained a specific performance provision for United Rentals against RAM, which was subject to Section 8.2(e); and (iii) Section 8.2(e), which provided that both RAM and United Rentals could terminate the agreement under certain circumstances, but limited all remedies to a $100 million termination fee and contained a provision barring equitable relief. Id. at 816–817. During lengthy negotiations, the provision regarding the specific performance remedy was deleted by the purchaser's counsel in multiple drafts and the purchaser's counsel indicated that the only remedy acceptable to the purchaser in the event that Cerberus Partners failed to consummate the equity purchase would be the $100 million termination fee. Id. at 817–823. However, the specific performance provision was ultimately left in the final draft, as modified by Section 8.2(e). Id. at 825–

826. When RAM backed out, the target company sought specific performance of the merger agreement by RAM. Id. at 827. The court agreed that recourse could not be had against Cerberus and Cerberus Partners (except under the guaranty if RAM did not pay the termination fee). Id. at 829. However, since the conflicting provisions in the merger agreement regarding specific performance and remedy limitation gave rise to an ambiguity, *parol* evidence became available to determine the true agreement of the parties. Id. at 833–834. Ultimately, specific performance was denied. Id. at 845. Again, the court noted that "[o]ne may plausibly upbraid Cerberus from walking away from this deal, for favoring their lenders over their targets, or for suboptimal contract editing, but one cannot reasonably criticize the firm for a failure to represent its understanding of the limitations on remedies provided by this Merger Agreement…" Id. Notwithstanding the court's opinion of the conduct of Cerberus and its related entities, the seller remained without recourse.

Pending Decisions in M&A Law and Possible Protective Strategies

Given the overall flux in credit markets and the economy in general, we believe there will be increasing challenges to director fiduciary duties in the merger and sale context. Recently, in *Berg & Berg Enterprises LLC v. Boyle*, 178 Cal.App.4th 1020 (Cal. Ct. App. 6 Dist. 2009), a California court rejected Delaware precedent and limited the scope of directors' duties to creditors of an insolvent California entity. In Delaware, when a corporation is within the "zone of insolvency," directors owe a fiduciary duty to creditors (e.g., as articulated in *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. 1991) and *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007)). Departing from this rule, the *Berg* court found that the board had a duty to avoid "actions that divert, dissipate or unduly risk corporate assets that might otherwise be used to pay creditor claims," but does not otherwise owe a duty to creditors. Id. at 1041. Notwithstanding this holding, we believe that the actions of directors will be under increased scrutiny by both shareholders and creditors. Therefore, care must be given to assist management as well as board members in exercising their business judgment to make informed decisions. In many situations, it is important to obtain expert valuation opinions and market studies to fully understand the competitive landscape.

Given overall depressed share prices, we also believe there is a likelihood of an uptick in hostile takeover attempts. As pre-emptive steps, anti-takeover measures should be explored, again being mindful of fiduciary obligations to shareholders. Also, given the fluctuating value of the dollar, we expect to see an increase in cross-border activity including strategic investments by sovereign wealth funds and investors. In the M&A context, deal defensive strategies will become more commonplace, including go-shop provisions and break-up fees. In addition, as the regulatory environment becomes more stringent, walk rights, detailed affirmative and negative covenants, and price adjustments will be subject to heavy negotiation. However, at all times, the necessary evaluations of the transaction by the board of directors must be undertaken in order to meet the *Revlon* and other tests.

Changing Negotiation and Settlement Strategies

Based on recent cases, we believe greater emphasis needs to be placed on careful drafting of M&A agreements. For example, *Alliance Data Systems*, 963 A.2d 746, clearly demonstrates the importance of making sure that all relevant corporate affiliates are bound by any M&A agreement.

The decision in *Alliance Data Systems* emphasizes that careful attention must be paid to which parties are actively bound by each provision of a merger agreement. It is not enough for a parent company or affiliate of the buyer to agree not to interfere with the transaction, but the parent or affiliate must agree to actively undertake obligations. In this case, only the Aladdin subsidiaries were signatories to the contract, and the Blackstone entities were not signatories, although certain limited negative covenants were given on their behalf. Id. at 749. To the extent that the parties contemplate that an affiliate or parent will play a limited role in the transaction, the drafter must carefully consider the implications of each covenant given or not given. It is not enough to assume that since the parent company, as owner of the acquirer or the target company, has consented to the agreement it will in all circumstances cooperate fully, regardless of its own interests. If only the subsidiary is bound, as in *Alliance Data Systems*, the subsidiary will always have the possible legal claim that, notwithstanding any "reasonable efforts" provision, it cannot control the actions of its parent and/or affiliate company, and if these entities are not parties to the merger agreement, the other party to the transaction will have no remedy against them in the event

the transaction is not consummated. When the company is a shell company, there may be no ability to recover a monetary judgment at all. This is an issue for both the buyer and the seller in that an uncooperative parent company or affiliate on either side could potentially undermine the transaction.

Alliance Data Systems further emphasizes the important distinction between an agreement not to place undue obstacles in the way of a transaction (i.e., a negative covenant) and an agreement to genuinely engage in one's best efforts to cause the transaction to come to fruition (i.e., an affirmative agreement). Frequently, these items are not the most heavily negotiated, and we believe *Alliance Data Systems* illustrates both the tendency to underestimate their importance and the extent to which a canny parent company or affiliate can insulate itself from liability. See also *United Rentals Inc. v. RAM Holdings Inc.*, 937 A.2d 810, where Cerberus Capital Management LP similarly controlled lengthy (and ultimately successful) negotiations to preserve its ability to avoid liability for its subsidiary's failure to consummate the transaction and to limit the amount of liability even for its subsidiary.

Further, we also believe *Alliance Data Systems* reflects a new economic and business reality arising from the recent recession: increased regulatory oversight. While the guarantees sought from the Blackstone Group, Blackstone Capital Partners V LP, and related entities by the OCC in this case seem unusually stringent (i.e., the OCC "wanted Blackstone and its affiliates to sign a wide-ranging acknowledgement of World Financial's regulatory requirements"), it is clear that, based upon the current recession, regulatory agencies are seeking greater assurances as to financial security. In particular, as discussed in *Alliance Data Systems*, the clash of expectations between the regulatory agency and the acquirer's ultimate parent, Blackstone, ultimately resulted in the undoing of the merger: "Blackstone saw itself as an investor protected by limited liability, whereas the OCC saw Blackstone as a source of funds that would make sure that World Financial continued to meet its regulatory obligations." Id. at 755. This development was unacceptable to Blackstone based on its prior practices: "[i]t was one thing for the regulatory agency to extract capital and other requirements from the operating company itself, but to go further and have a particular Blackstone fund—with obligations to its investors to return their capital on

agreed terms—tie up its capital through agreements with a federal regulator was highly problematic." Id. Such investors are no longer receiving the deference previously granted by regulatory agencies, who are seeking to extend regulation over not merely companies specifically regulated under law (such as World Financial), but parent companies not subject to the same requirements. Less deference to the protection of the corporate veil is being granted.

Therefore, the parties to an M&A transaction that are in industries that are subject to such regulations (in particular, banks and other financial service industry entities) should anticipate increased demands to obtain the requisite regulatory consents and draft their agreements accordingly. Such agreements should specify the actions the parties deem reasonable or unreasonable to be undertaken to obtain such consents, as opposed to relying on a generic "reasonable best efforts" standard. For example, in *Alliance Data Systems*, Aladdin Solutions agreed to use its "reasonable best efforts to take, or cause to be taken, all actions, and to do, or cause to be done, and to assist and cooperate with the other parties in doing, all things necessary, proper or advisable under applicable Laws to consummate and make effective...the transactions provided for" in the Agreement. Id. at 754. However, "Aladdin made no promise that it would cause BCP V or any BCP V affiliate to undertake any affirmative action to achieve OCC approval." Id. at 749. The absence of any specific obligations on behalf of Aladdin or its parent companies made it very difficult for Alliance Data Systems to allege a breach of the agreement due to failure to undertake its "reasonable best efforts." As the court said, "the time for ADS to have protected itself from the risk that the OCC would make demands that Blackstone would not accept was when negotiating the words of the Merger Agreement." Id. at 751. Even without the requirement that specific actions be undertaken by its parent companies, had Alliance Data Systems negotiated a requirement that Aladdin Solutions take certain steps toward obtaining the approvals, Alliance Data Systems would have had a much stronger action for breach of contract. As the agreement at issue was written, the court showed little sympathy for Alliance Data Systems and effectively placed the blame on Alliance Data Systems for its failure to negotiate carefully.

We also reiterate that *Hexion* stands for the principle that "reasonable best efforts" require communications between the target and acquiring company

when previously unanticipated obstacles to the transaction appear. While it is true a company cannot be deemed to be providing its reasonable best efforts by taking actions that could defeat the transaction, the *Hexion* court expressly held that the failure of Hexion to alert Huntsman's management to its concerns was *in and of itself* a breach. Consequently, we believe Delaware courts have effectively articulated that failure to negotiate and consult with the other party can be a breach of an acquisition agreement, and we feel that the important role of negotiations and discussions with the other party during an acquisition has been re-emphasized. Consequently, all substantive concerns, including those involving difficulties in obtaining regulatory consents, must be discussed between the parties.

Therefore, we believe in a renewed importance both in addressing the limited liability for parents and affiliates of parties to the transaction and the requirements placed on these entities with regard to acquisitions, and in defining the "reasonable efforts" to be undertaken by both the actual parties to the agreement and their related entities.

Negotiating an Acquisition Agreement

We were recently involved in an attempted acquisition that was ultimately terminated due to the inability to obtain the required regulatory consents from a federal regulatory agency. Certain regulatory approvals were sought from the agency to allow the target company to restructure in connection with a stock purchase. The federal regulator refused to approve the restructuring. Fortunately, the stock purchase agreement contained a number of provisions that were protective of the interests of both parties with regard to obtaining regulatory consent.

First, the stock purchase agreement contained a provision stating that each of the parties would "cooperate with the other and use its reasonable best efforts in good faith to take, or cause to be taken, all actions, and to do, or cause to be done, all things necessary, proper, desirable, or advisable on its part under this Agreement or under applicable laws to consummate and make effective the Transaction as promptly as practicable." However, the "reasonable best efforts" provision was subsequently expanded upon, as the agreement also contained a specific provision defining the parties' responsibilities thereunder. In particular:

> in connection with any proposed activity, acquisition or other event or transaction on the part of Purchaser or the Company that requires any consent or approval from, or filing or notice to, any Regulatory Authority (a "Regulatory Action"), each party hereto agrees to, upon the other party's written request, take such actions or refrain from taking such actions, provide such information and otherwise reasonably cooperate with the other party in each case as the requesting party or the applicable Regulatory Authority shall reasonably request in connection with such Regulatory Action, in each case, to the extent necessary to obtain any required consent or approval or make any required filing or notice. Notwithstanding the foregoing, neither party shall be required to take such actions or refrain from taking such actions, provide such information and otherwise reasonably cooperate to the extent doing so would reasonably be likely to result in the imposition of any conditions, restrictions or requirements that would be materially and unreasonably burdensome on such party.

Therefore, the scope of the parties' respective obligations as to providing their "reasonable best efforts" is defined.

Further, obtaining the requisite regulatory consents was deemed a condition precedent to the closing of the transaction, as to both the target company and the purchaser, thus making both parties responsible for obtaining the requisite consents. In connection with the conditions imposed by the agency to obtain the necessary regulatory approvals, the purchaser was protected from "any conditions, restrictions or requirements which would reasonably be likely (i) following the Closing Date, to, individually or in the aggregate, have a material adverse effect on Purchaser or (ii) to be materially and unreasonably burdensome on Purchaser. For purposes of this Section, any condition, restriction or requirement that would cause Purchaser immediately following the Closing to have voting control over less than all of the Shares purchased hereunder will be deemed to be unreasonably burdensome on Purchaser." Similarly, the target company was protected from "any conditions, restrictions or requirements which would reasonably

be likely (i) following the Closing Date, to, individually or in the aggregate, have a Material Adverse Effect on the Company, (ii) be materially and unreasonably burdensome on the Company or (iii) to require the sale by the Company of any assets."

A material adverse effect was defined elsewhere in the agreement as meaning:

> any effect, circumstance, occurrence or change that is material and adverse: (i) to the business, assets, results of operations, financial condition of the Company, taken as a whole; or (ii) the ability of the Company to consummate the transaction or perform its obligations under this Agreement; *provided, however*, that Material Adverse Effect shall not be deemed to include (A) any effects, circumstances, occurrences or changes generally affecting the commercial banking industry, the economy, or the financial, real estate, securities or credit markets in the United States or elsewhere in the world, including effects on such industry, economy or markets resulting from any regulatory or political conditions or developments, or any outbreak or escalation of hostilities, declared or undeclared acts of war or terrorism, (B) changes or proposed changes in generally accepted accounting principles in the United States (GAAP), (C) changes or proposed changes in laws governing financial institutions and laws of general applicability or related policies or interpretations of any Governmental Authority), (in the case of each of clause (A), (B) and (C), other than effects, circumstances, occurrences or changes that arise after the date of this Agreement but before the Closing to the extent that such effects, circumstances, occurrences or changes have a materially disproportionate adverse affect on the Company relative to other companies in the commercial banking industry), or (D) changes in the market price or trading volume of the Company's Common Stock (it being understood and agreed that the exception set forth in this

clause (D) does not apply to the underlying reason or cause giving rise to or contributing to any such change).

While the regulatory approvals required for this transaction were not ultimately obtained, and the parties mutually and amicably agreed to terminate the transaction, had the matter been forced to go to litigation, both parties would have had the benefit of a specific standard that determined what was acceptable to each party as a condition of obtaining regulatory approval (i.e., the purchaser would not have restrictions on voting its shares, and the company would not have been required to sell any of its assets, or have experienced a materially adverse effect, as specifically defined in the agreement). The parties were under an express obligation to cooperate and to share information to obtain any required regulatory approvals, while the actions they could not be required to take to obtain the approvals were defined as well. Further, the definition of a material adverse effect was also clearly spelled out to exclude general conditions. This agreement was heavily negotiated between the parties, but ultimately provided the protections necessary for both parties without compromising the requirement that they both exert their "commercially reasonable best efforts" to facilitate the transaction.

Looking to the Future

We believe that, going forward, in addition to the likely increased regulatory scrutiny and possible "material adverse effects" of the economic slowdown, the balance of power in negotiating provisions will shift. Generally, for much of 2010, we believe the power balance will be in favor of the purchaser (as in *Alliance Data Systems*, where the purchasing entity had the ability to isolate its parent companies from undertaking any affirmative obligations). However, there will be situations such as those in *Hexion* as well (where the seller actually had the power, because it was in a bidding war) where the seller has greater power. *Hexion* in fact illustrates the peril of a company being so eager to enter into a transaction that it may not undertake complete due diligence and/or compromises its negotiating ability as to the legal terms (as opposed to business terms) of a transaction. As discussed in *Hexion*, "because the buyer and its parent were eager to be the winning bidder in a competitive bidding situation, they agreed to pay a substantially higher price than the competition and to commit to stringent

deal terms, including 'no financing out.'" *Hexion*, 965 A.2d 721. Similarly, in *Hexion*, because the agreement was so heavily slated toward the seller, the definition of "material adverse effect" in the agreement was not protective of the buyer's right to terminate the agreement, and damages potentially available to the target company were not capped for a "knowing and intentional breach" of the agreement by Hexion, with a $325 million liquidated damages provision against Hexion for failure to obtain financing. Id. at 724. Also, Hexion had no right to terminate the agreement based on the potential insolvency of the combined company post-merger. Id. at 725. These provisions, in combination, severely restricted Hexion's ability to deal with a situation where economic conditions changed drastically (as they did between 2007, when the agreement was signed, and 2008, when it was terminated), and adversely affected the value of the proposed transaction.

Hexion constitutes a cautionary tale as to the adverse impact of an uneven balance in power. For another example, we point to a recent unpublished decision by the Chancery Court of Delaware, *Airborne Health Inc. v. Squid Soap LP*, 2009 WL 4061826 (Del. Ch. 2009). In this case, Squid Soap, a company that produced specialized soap products, was acquired by Airborne under an asset purchase agreement that provided for a $1 million purchase price at closing, with additional earn-out payments that required that the purchaser, Airborne, incur a minimum of $1 million in market costs and achieve net sales of $5 million of Squid Soap products within one year, or transfer the assets of Squid Soap back. Id. at *2–3. However, the covenants made with regard to marketing by Airborne were not a "mandatory commitment" to expend such funds, but merely a condition that required Airborne to return the assets if these goals were not achieved. Id. at *4. The asset purchase agreement, while including a representation by Squid Soap that no litigation was pending or threatened against Squid Soap, except as disclosed in the agreement, only contained a representation by Airborne that no legal proceedings were pending or threatened that "are reasonably likely to prohibit or restrain the ability of Purchaser to enter into this agreement or consummate the transactions contemplated hereby." Id. at *8.

After the transaction closed, it turned out that at the time of negotiations, significant litigation was pending against Airborne and it was being investigated by the Federal Trade Commission and the attorneys general of

over thirty states in connection with false marketing. Id. at *5. The marketing and net sales provisions of the asset purchase agreement were not met, and Squid Soap sued Airborne. Id. at *6. The court held that since the pending litigation did not affect the *consummation* of the asset purchase, Airborne had not technically violated its representations and warranties. Id. at *9–11. Further, the court refused to expand the representation made by Airborne on the basis that it would effectively convert this provision "into an obligation to disclose litigation that could have a material adverse effect...on Airborne's business." Id. at *11. The court said that if Squid Soap sought such a provision, it "could have bargained for it. The negotiations over such a provision would have involved numerous drafting issues, including the phrasing of the basic standard (e.g. is/will/would/might/could [reasonably] [likely to] have [versus not have] a material adverse effect), whether to expand the impact to the business and its prospects, whether to use quantifiable standards, the inclusion of carve-outs, and a host of other issues." Id. (brackets in original). However, the agreement "does not contemplate MAE-based litigation disclosure and [the court] will not re-write the APA to include such a provision." Id. Further, the implied covenant of good faith and fair dealing did not apply to the earn-out provisions because Airborne is not expressly obligated to expend the resources to conduct marketing, and while there were express targets upon which the parties agreed, Squid Soap did not plead that Airborne failed to meet the targets arbitrarily or because of bad faith, but because of a "corporate crisis." Id. at *17–18. There was no "best efforts" provision. Id. at *19. Thus, *Airborne Health* further illustrates the dangers of imprecise drafting and demonstrates that non-business terms can be just as important as business terms.

Because of the general market conditions, we believe that power generally will be slanted toward the purchaser in the near future. Consequently, indemnities, termination provisions, and the representations and warranties required to be incorporated into the agreement are likely to be buyer-oriented. For example, it is likely that the seller will be required to make additional representations and warranties with fewer knowledge and materiality qualifiers. The ability to terminate an agreement will likely be granted in more situations to the buyer than the seller. As to the indemnities given by sellers, the caps will be higher and claim thresholds lower. Moreover, as in *United Rentals Inc.*, the seller may seek to require

guarantees by the controlling entity of a company (such as Cerberus) of performance by the actual operating company/purchaser of its obligations under the merger agreement.

As we have previously discussed, going forward, we are looking to define more precisely the obligations of the parties to take action to consummate a transaction (beyond merely engaging in their "reasonable best efforts"). Parties must anticipate greater difficulties in obtaining regulatory approvals and draft acquisition agreements accordingly.

Further, we believe additional emphasis needs to be placed on "walk rights" based on material adverse effects and other conditions. However, based on *Hexion* and the clear hostility of the Delaware courts to companies that seek to terminate acquisitions based on materially adverse effects, to the extent that a party wishes to functionally have the ability to terminate based on a material adverse effect, the definition must be very clear. Conversely, based on the current economic conditions, it would be inadvisable for a party to allow the other party to terminate based upon a material adverse effect that is not specifically linked to the target company, as the recession could generally constitute a material adverse effect for almost any acquisition agreement. Therefore, we foresee a greater importance being attributed to negotiating such provisions.

New Strategies for Structuring Legal Documents

Due to recent developments in this area, we have been paying particular attention to revising our acquisition agreements. As we have described, we have focused on defining what "reasonable commercial efforts" mean to each party in each unique situation in order to ensure that the parties have a meeting of the minds in relevant situations as to precisely what the contract binds them to, and what conditions are unreasonable for the consummation of the transaction.

Similarly, we have reevaluated the importance of provisions that allow either party to terminate the transaction in certain specified circumstances (of which material adverse effect clauses are merely one example). For example, in the transaction discussed previously, the acquisition was ultimately terminated for the inability to obtain regulatory consents;

however, due in part to the negotiated provisions, the parties were able to amicably terminate the transaction in full confidence that both sides had fulfilled their obligations to exert their reasonable efforts to obtain same.

Overcoming Major Hurdles

The first hurdle many of our M&A clients may be facing in the coming year is the increased regulatory burden we anticipate may be imposed upon acquisitions. It is clear from recent press reports as well as cases like *Hexion* that regulators are imposing requirements to obtain acquisition approvals that have never before been seen in the financial industry—from the language of the opinion, even the judge acknowledged that the demands being made by the OCC were unusual and excessive. The essence of the benefit of limited liability created by having a multi-layer parent-subsidiary structure and in having affiliates is that the ultimate parent is not responsible for the financial obligations of the ultimate subsidiary. It is no coincidence that *Hexion* (owned by Apollo Management Group), *United Rentals Inc.*, and *Alliance Data Systems* (parent company was Blackstone Group) all involved private equity groups. Like certain hedge funds, private equity groups are very involved in a variety of industries and have provided investment funds to many different companies, based on the premise that the liability of the private equity investors is limited, and that the corporate veil will not be pierced to allow investors to be liable for the companies' received funds, which are in a variety of industries. However, hedge funds and private equity groups are not heavily regulated entities. Continued regulatory efforts to "pierce the corporate veil" for regulatory requirements will not only complicate the process of obtaining regulatory approvals (as in *Alliance Data Systems*), but may also result in decreased investment by certain types of funds and private equity groups.

We will advise our clients to be prepared to experience difficulties in obtaining regulatory approvals for acquisitions, and we will draft our agreements to more carefully define the obligations of the respective parties in obtaining same. Clients can be prepared for the increased difficulties by carefully maintaining their files as to correspondence with regulatory agencies, allocating additional time prior to closing the transaction for obtaining such approvals, and ensuring that they generally remain in compliance with all regulations, so as to ensure a simpler review and more

comfort by the regulatory agency. They should anticipate the necessary information that must be provided to the agency and procedures required, as well as demands likely to be made of any parent and/or affiliated companies so that the agreement may allocate responsibilities accordingly.

We also believe the due diligence required to successfully consummate an acquisition is increasing and will continue to increase over time. First, investors will require more information (in particular, with regard to historic financial disclosures and forecasts) in these times of reduced credit. Further, the necessity of fully understanding a company's current and anticipated financial condition is illustrated by *Hexion*. According to the background information provided in the case, Huntsman began to solicit bids in May 2007. *Hexion*, 965 A.2d at 723–724. Hexion was among the bidders, and made a previous offer before signing a deal on July 12, 2007. Id. at 724. Based on these expedited timeframes, it appears questionable whether Hexion had the opportunity to conduct sufficient due diligence before making its final bid, and the opportunity to negotiate the agreement fully. The panic at Hexion arose after Huntsman's financials for the first quarter of 2008 were released and Hexion was forced to reevaluate its business model. Id. at 725. It appears that the private equity group that controlled Hexion, Apollo, may have made representations to its investors regarding returns that could not be achieved given the unfortunate first quarter results of Huntsman. Id. at 725, fn. 8.

Consequently, given the current economic climate, we will encourage our clients to engage in more detailed due diligence, particularly as to financial documents. First, the economic climate is currently very unstable, and large losses appear possible in many sectors of the economy going forward into 2010. Further, it is much more difficult to obtain credit at this time than it has been historically. It appears likely that both institutional lenders and private investors will require more information than in the past before lending money. As in *Hexion*, failure to negotiate a financing contingency into the agreement could potentially be disastrous in the event that the purchaser has difficulty in obtaining credit. In *Hexion*, failure to obtain credit would have resulted in the seller receiving the contractually stipulated damages of $325 million. Id. at 721. In its efforts to avoid paying this significant amount of money upon discovering solvency concerns that Hexion knew would endanger its ability to obtain financing, Hexion instead

committed a breach of the contract that was deemed "knowing and intentional" by the court, resulting in no cap on the damages potentially available to Huntsman. Id. at 757. Neither choice was beneficial for Hexion, and it was left in a very unfortunate predicament that could potentially have been avoided with a greater opportunity to conduct due diligence prior to entering into the transaction or by negotiating the financing provision differently.

We also intend to revise our initial due diligence queries to be more specific. Clients can be prepared to facilitate due diligence by reviewing their files comprehensively and collecting relevant data prior to the initiation of any acquisition talks. All responsive information needs to be provided simultaneously for review by the other party. Due diligence should not be viewed as a formality that must be complied with in order to provide a reasonable basis to approve a transaction, but as a valuable opportunity to either explore the condition of the target company or, conversely, to explain the precise state of the target company to the potential acquirer in order to avoid misunderstandings that could potentially threaten the transaction. Expeditious and full compliance with requests will facilitate the completion of the transaction and form trust between the participants. Last-minute surprises are not good for either party, and may lead to risks that are not contemplated by the original transaction document. For example, we have participated in a transaction where due diligence materials were still being provided by the sellers days before the closing after nearly one and a half years of negotiating the acquisition agreement, as the target did not organize its information production. The transaction was seriously threatened at many points due to the surprises that constantly arose and required redrafting of the agreement on multiple occasions, resulting in delay and greater expenses for all parties involved.

Finally, we believe that in light of the current economic conditions, it will be necessary to provide the parties with additional opportunities to exit the transaction if necessary. Unanticipated downturns in business or in a specific industry may result in the transaction no longer being as desirable to either party. Therefore, it will be important to negotiate provisions allowing termination in a variety of situations, such as due diligence issues. For example, additional rights of termination based upon information obtained during due diligence after entering into the agreement could have

saved Hexion from its predicament. This is primarily a drafting issue, although clients again must appreciate that the legal terms of the transaction are nearly as important as the business terms, and evaluate negotiations accordingly.

The Impact of a New Administration

We believe the change in administrations from the Bush administration to the Obama Administration has resulted in a different regulatory climate for our M&A clients. We note that there are a number of initiatives and items of pending legislature that would regulate the credit industry and financial services industry more closely. Further, as we previously indicated, we believe that generally, regulatory agencies will impose more significant requirements to obtaining the requisite consents for an acquisition. As we have previously addressed the additional regulatory burdens at length, we would like to additionally note that the issue of executive compensation has also become a particularly hot issue.

Executive compensation has become a very relevant and timely consideration. In particular, we note that in mid-December, Kenneth Feinberg, President Obama's pay czar, announced rules that restricted the amount of compensation for executives of companies that have received federal bailout funds under the Troubled Asset Relief Program and other programs. Further, in addition to setting a specific amount of pay, Mr. Feinberg also imposed the requirement that a portion of these executives' compensation be in "long-term" compensation, such as stock that is required to be held for at least three years. While these requirements are applicable to companies that have received federal stimulus funding and not repaid the same, we believe this signals a trend throughout the industry. For example, Goldman Sachs (which has already repaid its federal loan and is not technically subject to these requirements) announced in a December 10, 2009, press release that it would not pay cash bonuses for its management committee, but would award stock that must be retained for a minimum of five years ("shares at risk"), which would allow the firm to recapture shares in the event that the employee took undue risks. See Press Release, Goldman Sachs, "Goldman Sachs Announces Changes to 2009 Compensation Program" (December 10, 2009), available at www2.goldmansachs.com/our-firm/press/press-releases/current/ compensation.html.

Therefore, we believe the renewed current focus on executive compensation could have an impact on M&As in 2010 and in the future. In particular, it may affect earn-outs. As deferred payments to the seller of a company, earn-outs fit in with the current trend against short-term compensation in order to ensure long-term results and may become more common, particularly in the troubled economic conditions that may make it difficult to pay a premium purchase price up front. Earn-outs also have the benefit of allowing the purchaser to evaluate an acquired company's results over time. Consequently, we believe earn-out provisions may become more common with regard to the sale of a company when individual shareholders are involved. It is also possible that we will begin to see earn-outs that are structured over a longer period of time. However, the seller may experience an inability to hit the earn-out targets that is caused not by the company's operations, but by the general market conditions as well.

For a cautionary example, we point once more to *Airborne Health Inc.*, 2009 WL 4061826. As illustrated by this case, it is essential for the party receiving an earn-out to carefully draft the relevant provisions. In *Airborne Health*, the court held that since the agreement provisions did not make the buyer's provision of marketing funds and net sales goals mandatory (merely providing that the purchased assets would have to be returned if these actions were not taken), there was no remedy for breach of contract when the buyer failed to do so. Id. at *11. The court further expressed an unwillingness to expand the transactions contemplated by the asset purchase out to include the subsequent earn-out, without express language in the agreement. Id. Therefore, any seller receiving an earn-out must make the performance of any post-closing agreements by the buyer an express obligation, and must carefully specify the requirements to be imposed upon the buyer. *Airborne Health* further illustrates both the difficulty of achieving earn-out goals in the current economic environment and the necessity for detailed due diligence (had the seller been aware of the agency investigations and litigation surrounding the products sold by Airborne, it might have taken greater care with drafting, or not undertaken the transaction at all).

The *Airborne Health* court noted that "[w]hat an earn-out (and particularly a large one) reflects is disagreement over the value of the business that is bridged when the seller trades the certainty of less cash at closing for the prospect of more cash over time. In theory, the earn-out solves the

disagreement over value by requiring the buyer to pay more only if the business proves that it is worth more only if the business proves that it is worth more." Id. at *3. Clearly, the court recognizes the value of an earn-out as a negotiating tactic. However, it warns that "since value is frequently debatable and the causes of underperformance equally so, an earn-out often converts today's disagreement over price into tomorrow's litigation over the outcome." Id. Consequently, careful drafting of earn-out provisions is vital both in protecting the interests of the seller and in preventing subsequent litigation by the seller simply because the earn-out goals have not been met (regardless of the contributing factors). Effectively, one can see this as an outgrowth of the "reasonable efforts" standard we have previously discussed at length herein, by extending agreed-upon reasonable efforts by both parties beyond the closing.

The Economy's Effect on the M&A Market

The economic downturn has certainly affected M&As. Aside from acquisitions becoming less common generally, as we have discussed, the uncertainty created by the current economic climate requires greater drafting care for all parties. Buyers will want to provide for additional termination rights and additional due diligence. Sellers will want additional certainty that the buyers can obtain financing and that they will follow through on the transaction (*United Rentals Inc.* provides an example of the importance to the seller of certainty given that the seller continually sought to have the shell subsidiary's parent company guarantee the subsidiary's obligations to perform the transaction contemplated by the merger agreement). As in *United Rentals Inc.*, sellers may seek to insert a requirement of specific performance. However, generally, we believe buyers will have greater power to negotiate provisions because it is a buyer's market.

We do believe, however, that although the recession is certainly a negative occurrence, positive developments may rise out of the caution that we perceive is currently deemed necessary, and will be deemed necessary to negotiate and consummate acquisitions successfully in the near future. For example, more careful drafting, the obligation to participate in substantive discussions regarding all issues that arise during the road to closing a transaction, and increased due diligence requirements are quite possibly, in the long run, beneficial for everyone undertaking an acquisition.

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M&A Deals in a Down Economy: New Trends and Strategies

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Recent Trends in M&A Law

The most important developments in mergers and acquisitions (M&A) law are much less concerned with new decisional law or new legislation. Instead, they are driven by political, regulatory, and economic changes, and especially by the devastating economic collapse of 2008–2009, which has resulted in the near absence of banks from the lending markets. With virtually no debt financing available to buyers from conventional bank sources, a higher percentage of deals have involved strategic buyers who have cash or will do stock deals. Similarly, the shortage of bank debt and the worldwide trend toward globalization have brought significant new numbers of international strategic buyers into the domestic M&A market.

Globalization is, therefore, an important trend in M&A that has been accelerated by the difficulties in the capital and debt markets. Since 2007, we have seen an increasing number of foreign buyers in the domestic M&A market. My firm has an office in China, and our practice has rotated to representing Chinese buyers in the United States, whereas for most of our fifteen-year history in China we represented U.S.-based multinationals in doing joint ventures or buying or opening new ventures in China. The trend of foreign buyers making deals in the United States has accelerated hugely, both because of the ability of the Chinese and the Indian economies to grow in a down global market, and the depth of the recession in the United States, compounded by the decline of the dollar over the last four to six months. Although the dollar strengthened recently, it is still near historical lows, down approximately 20 percent compared to global currencies. That has put many aspects of the U.S. market on sale again—much like the situation in the early 1980s, when the Japanese were buying up America.

Ten years ago, about 90 percent of the deals in my M&A practice were domestic deals, conventionally financed or purchased by strategic buyers. Recently, however, at least a strong plurality, if not the majority of our transactions, particularly on the West Coast and the Pacific Rim, involve international strategic buyers.

Unfortunately, many sellers missed the last cycle—they did not sell when their earnings and EBITDA multiples were at their peak. Many smaller, middle market companies have an aging owner or owners who are now

extremely eager to sell because of the recent recovery in the economy—to the extent there has been a recovery. Many of those companies are now rebuilding their earnings and EBITDA, and are motivated to sell. Therefore, foreign strategic buyers currently have an advantage, because there are many companies in the middle market looking for a transaction, and there are relatively very few domestic buyers.

Joint Ventures

Throughout my forty-year career, I have structured many joint ventures. During most of that time, I did not view a joint venture as an alternative to an M&A transaction; rather, it was often a stepping stone to an M&A transaction, and one that was not certain to occur. In many cases, the joint venture would have been done even if there was no inclination for it to end up as an acquisition.

Now, however, because of the difficulty in financing transactions and because a number of foreign buyers are not yet ready to make the leap to buy a U.S. company outright in an M&A transaction, an increasing number of global companies are coming to the United States looking for joint ventures in which they can get their "toe in the water." They then do their due diligence in the operation of the joint venture. In almost every such case, a joint venture is now a clear, short-term stepping stone to an M&A transaction. Consequently, my firm and the markets have been beneficiaries of joint ventures as both an initial alternative and, more importantly, as a key step toward an acquisition in an M&A transaction.

Domestic Joint Ventures

I was recently involved in a domestic transaction that tracks, in an interesting way, the phenomenon I have described concerning M&A transactions and joint ventures. It involved a major California company looking to grow into the Pacific Northwest markets. One of our client companies fit the California company's acquisition criteria, but they worried about whether our client had the depth of management to integrate the companies successfully. The California company had a nearly $1 billion acquisition line, yet they did not offer to buy my client; they proposed a toehold acquisition of roughly 20 percent of the stock, board seats, and modest blocking power for major

changes in the target company. They then drew up highly incentivized management agreements with the principle management of the target, and wrote what is in effect a joint venture agreement in the toehold stock purchase agreement. Therefore, for a period of one to four years, this "couple," by analogy, is going to live together and decide if they want to get "married." In drawing up the contract agreement, we inserted a "put" and a "call" for the buyer and a later "call" for the seller. If the joint venture is successful, the sellers can put the balance of their stock to the buyer. If that put is not exercised, the California company has a later call on the balance of the stock, with a formulaic purchase price. If that call is not exercised, my client can then buy back the minority interest.

What I find interesting about this deal is that this buyer could have made an acquisition, but they recognized this was a new market, and they needed to establish their faith in the management of the target company. Therefore, they were willing to accept this toehold minority interest, which acquirers almost never do, as a step toward a joint venture that will almost certainly—if this "couple" ultimately gets along as well as they currently think they do—result in a "marriage" (i.e., an acquisition).

Another example, although slightly atypical, is a transaction my firm and I are currently working on in which a multinational chemical company will enter into a joint venture in China with a client who has patents on a heavy metal recycling technology. The joint venture will operate for a few years in China, and then the multinational chemical company will have a call to buy out our client's interest and to have an exclusive license to practice the technology in China.

Major Hurdles for M&A Clients

Perhaps the biggest hurdle clients need to overcome these days is mindset. If your condo was worth $600,000 a year and a half ago, it is only worth $350,000 to $400,000 today, but most people cannot get their mind around that fact, and do not change the valuation on their balance sheet. Similarly, someone who did not sell their company in the tremendous run-up of M&A multiples pricing in 2007 still wants to believe his or her company is worth what it was previously. In almost all cases it is not, because their three-year trailing EBITDA average is lower, and because multiples are lower.

Therefore, even a highly motivated seller who thinks it is time to sell his or her company often has a really tough time with the valuations that are currently being offered. There are, of course, isolated exceptions to the difficulties in this area. For example, we recently closed an auction deal for a medical equipment component manufacturer. We thought we would be lucky to have three credible bidders. Initially we had eleven bidders, and we ended up with seven credible ones. In that case, I had a very happy seller client, but such a scenario is the exception these days. This company was fortunate to be in such a strategic market. The more mundane manufacturing companies are seeing pricing that is substantially lower than what many companies might have gotten during the run-up of 2001 to 2008.

MAC Clauses and Other Key Contract Terms in M&A Deals

Material adverse change (MAC) clauses are always important and fought over in the M&A context. The recent decision of the Delaware Chancery Court's in *Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008), underscored how important these MAC clauses are. In *Hexion*, the buyer in an M&A deal attempted to invoke the MAC provision after the economy turned, and the target's gross sales and EBITDA went down fairly moderately. The buyer tried to argue that an MAC had occurred in the transaction, but the court said these alleged changes did not supply an out.

The *Hexion* court first noted that no Delaware court had ever found an MAC to have occurred with respect to a merger agreement. They made it clear that the burden of proof thereafter was on the buyer asserting the MAC to excuse its performance. At least in *dicta*, they interpreted traditional MAC provisions to require a major distortion in the target's performance (in comparison to its past performance), which was likely to cause substantial long-term effects on its earnings and the future earning power of the target. The drafting lesson of *Hexion* is to be very specific on behalf of a purchaser with respect to closing conditions, such as earnings targets, EBITDA, and other quantifiable terms the buyer intends to excuse performance.

Bankruptcy Trends

Recent trends in the bankruptcy area are also affecting the drafting of contract provisions. Our bankruptcy group is busier than they have ever

been, and they are seeing bankruptcy courts playing a more activist role, particularly with respect to M&A transactions. M&A lawyers need to be very diligent in following trends in the bankruptcy courts, so that, if a deal ends up in bankruptcy, they will know what the bankruptcy courts are likely to do with or to that deal, and can draft carefully to anticipate those eventualities. I think bankruptcy judges are often seen as the court of last resort to deal with and repair broken deals, and they are becoming more aggressive in that role. Consequently, every transactional lawyer needs to stay on top of bankruptcy developments.

In almost every deal I have ever done, I have had an Employee Retirement Income Security Act lawyer looking at the Employee Retirement Income Security Act issues; I have had an environmental lawyer looking at the environmental issues; and I have had a labor and employment lawyer looking at the labor and employment issues. However, I have not always taken a deal to a bankruptcy lawyer and said, "Go through this term sheet with me, and tell me where there is exposure for my client if there is an event of bankruptcy that could affect this transaction." Going forward, I believe more of us will make a bankruptcy/creditors' rights lawyer a member of the M&A team, at least in terms of screening the term sheet and giving us a heads-up on issues we should address differently.

Changing Strategies and Practices

Deal flow has been down in recent times and, to some extent, average transaction prices are down as well. Over the last ten years, the bulk of the income in most major law firms has come from the transactional side. However, in the last year, many firms have seen a growing percentage of their revenues coming from litigation. If major firms are to gainfully and profitably employ their corporate and transactional lawyers, they are going to have to increase their marketing and business development efforts to increase their market share of those transactions that are being done and funded in this challenging time.

Is Deal Flow Increasing?

Happily, I believe things are beginning to loosen up in the marketplace. People are realizing the world will go on despite the recent economic

downturn, and there are some tremendous bargains out there in the M&A market. There are good platform companies that have suffered and are more inclined to sell, whether by choice or necessity. Buyers are beginning to come out of the woodwork.

Return of the Banks?

I think the last catalyst for a return to a robust M&A market is on the lending side. Banks are focused on building their balance sheets. The banks that received Troubled Asset Relief Program (TARP) money are prototypical. The money they received was not lent; it merely built up those banks' balance sheets, capital ratios, and cash reserves. Essentially, the banks that got the TARP funds got their earnings up and their losses written down, or off, so they could go out and do stock offerings. Bank of America, for example, recently raised approximately $20 billion or more and then entered into a preliminary agreement to pay off the government's TARP investments. What Bank of America did not do, and what Wells Fargo and the major money centered banks around the country did not do, was to prime the pump of the economy by lending that money. This is especially true in the middle market; the regional banks have shut down their lending except for very good, existing clients. I am somewhat puzzled by the Obama Administration's failure to focus on that issue, but I think it was a matter of priorities—the critical issue was to stop bank failures, rebuild the banking system, and avoid a total collapse.

Now, as previously indicated, many banks are getting ready to buy back the government's TARP position. A number of the smaller regional banks that were in real trouble have been shut down or sales have been brokered. Many of the regional banks and other survivors have gone to the capital markets and strengthened their balance sheets. I hope the administration and the market will soon encourage banks to get back into the lending game on a reasonable basis. When it comes to lending, banks often swing all the way to the right on the pendulum, or all the way to the left; either they throw money at any deal, or they simply shut down lending. Right now, they are shut down, but hopefully the pendulum will soon swing back to the middle.

The Impact of a New Administration on M&A Law

I do not think the new administration has had a major effect on M&A law or markets. It has, however, had a marginal effect on regulatory law with respect to consumer products companies. The Consumer Product Safety Commission Act revisions and the appointment of new leadership at the commission will mean much tighter regulatory oversight. This will affect deals in terms of perception of risk in buying those companies that are in that consumer product space.

As I mentioned previously, antitrust and trade regulations have been generally tightened up. There is concern that with many sellers having no option but to sell, those large companies that already have huge market share will further increase their market share by acquisition. It is feared there will be antitrust market share and pricing problems going forward—and, therefore, the need for increasing antitrust scrutiny.

Notwithstanding my comments about the failure of banks to lend their TARP funds, I still think the biggest and most positive effect of the Obama Administration on the M&A market has been its stimulus program. I recently attended a speech by the chief financial officer of a major Fortune 50 corporation who told a group of 500 chief executive officers and C-level executives that his corporation believes that if the Obama Administration had not intervened with the stimulus program, we would have faced not only a domestic but probably a global depression not dissimilar to the Great Depression of 1929. It is very easy for all of us to pick at the specifics of the stimulus program, but many think that it saved this country's economy, and it may have saved the world's economy. Many commentators believe we were standing at the abyss and ready to "fall off the cliff." Having said that, my criticism stands that, after the stimulus program built a fence at the cliff point and stopped people from falling off, there has not been enough focus on how we can rebuild the economy and create jobs by getting the banks back in the lending game.

Looking to the Future

Every week I see positive signs of normalization, but I know there is more bad news to come. We are going to see significant problems in commercial

real estate and in commercial real estate loans most of the way through 2010; and if the situation is bad enough, it could drag the whole economy down and take us backward. However, I do hope the situation is isolated largely to real estate, and that the general economy will continue to improve.

Although experts in the stock and bond markets continue to tell us they believe this recovery is real, there is a minority of analysts who think we are in for a secondary correction. I continue to believe we are going to get through this, although it is going to be a slow and iterative process. I think jobs are increasingly critical, not only to the economy but to the politics of the economy. If the Democrats do not rebuild the job base, there will be big changes in Congress in this next election. Nevertheless, I am hopeful that we are putting one foot slightly in front of the other on a weekly basis, and are coming out of this recession.

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Mr. Stewart frequently authors chapters and gives presentations on mergers & acquisitions law, cross-border transactions, and structuring joint ventures. He earned his J.D. from Indiana University School of Law.

Key Decisions Affecting M&A Transactions

Byron F. Egan

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ASPATORE

Recent Trends in M&A Law

My practice today is principally concerned with mergers and acquisitions (M&A) and corporate governance, and the two tend to intertwine. I advise boards of directors, and both buyers and sellers.

The primary trend in recent M&A activity has been changes in deal flow, which declined significantly earlier in the year, although it has been picking up recently. Indeed, my practice has been fairly active all year long—not just with respect to traditional M&A deals, but also in dealing with the problems and issues that are arising with respect to M&A transactions. Many of those issues are corporate governance-related.

Other issues relate to a deal that has already been done, and what the parties can do with respect to any conditions that are changing (i.e., once the merger agreement is signed, can a party get out of it if conditions change?). Simply drafting a provision in a merger agreement that provides that a party is not obligated to close if there has been a material adverse change in the business or condition of the target company—commonly called a material adverse effect—does not guarantee that a buyer can get out of a deal when the conditions change. In *Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008), the Delaware Chancery Court determined that a material adverse effect, as defined in the merger agreement, had not occurred even though the target's EBITA (earnings before the deduction of interest, tax, and amortization expenses) projections were down 32 percent from its forecast the previous year. Vice Chancellor Lamb wrote that the court views an adverse change from the longer-term perspective of a reasonable acquirer. Although the target's earnings dropped significantly from the signing of the merger agreement to closing, the court stressed that poor earnings results must be expected to persist significantly in the future, and should be measured in years, not months. The court suggested that if buyers want targets to meet expected forecasts, then buyers should negotiate for representations and warranties that specifically call for living up to those forecasts.

Proving a material adverse effect is extremely difficult in Delaware. Vice Chancellor Lamb commented in *Hexion* that the Delaware courts have never found a material adverse effect occurrence in a merger agreement.

Performance Issues in Today's M&A Deals

Financing is still a major issue in M&A deals. During the first part of the year, financing was very difficult to obtain. While financing is still not easy to get, the lending markets are opening up somewhat.

In the past, when someone came knocking at the door with a bid in an M&A transaction, a seller would typically say, "Show me the money." In other words, "If I am going to spend time getting ready for this transaction, I have to see that you, as a bidder, are really willing and able to perform." In the past year, this inquiry has become even more rigorous. Previously it was partially defensive, in terms of separating the wheat from the chaff, but now it is increasingly important to establish early on whether you want to spend any time talking to a potential buyer.

If you are a seller in an M&A deal and you let someone look at your books and records but they fail to make a bid, or they bid and the deal does not go through, you could wind up a victim of the "damaged goods" syndrome. Even absent that, there is the time and effort associated with helping a bidder with due diligence, and there is some risk that the bidder is going to come through with an offer that is substandard, or that they will spend a lot of time working with you on the deal, and then not be able to perform. Therefore, inquiries are more intense today in terms of whether a bidder can and will really perform, and bidders have to recognize that reality.

A recent Delaware Chancery Court case is a good illustration of why a seller wants to have confidence that it is dealing with a buyer that is financially able to close the transaction, and is contractually committed to doing so. *Alliance Data Systems Corp. v. Blackstone Capital Partners V L.P.*, 963 A.2d 746 (Del. Ch. 2009), *aff'd*, 976 A.2d 170 (Del. 2009), teaches that when the buyer is a private equity fund, the seller may seek to get contractual promises from the fund, and not just from the thinly capitalized acquisition vehicle, if the seller wants recourse to the assets of the fund.

In *Alliance Data Systems v. Blackstone Capital Partners*, the court dismissed the target's claim that the buyer breached the merger agreement by failing to use its reasonable best efforts to cause its affiliates to take actions requested by the regulatory authorities (generally to commit to provide capital support

for a bank owned by the target) in order for them to give regulatory approval to the merger. The question was whether the failure by the buyer to cause affiliates of the buyer to undertake certain actions requested by the regulators violated the reasonable best efforts clause in the merger agreement. The court concluded under the language of the agreement that the buyer had not contracted to cause its affiliates to so act, and its failure to do so did not violate (i) a provision of the merger agreement requiring the buyer to use its reasonable best efforts to obtain regulatory approval, (ii) a promise by the buyer to keep its affiliates from preventing the completion of the merger, or (iii) a representation by the buyer that it had the power to fulfill its commitments under the merger agreement. While the case illustrates the importance to the seller of getting promises from the money when the buyer is a private equity fund, extracting the promises is easier said than done.

Another big issue in this economy is whether a deal will actually close. For the seller, having specific performance as a remedy available is often a positive factor in terms of getting a deal done. When an agreement requires specific performance from the potential buyer, the buyer has some contractual assurance that the buyer can be required to complete performance of all the obligations under the contract, which gives more incentive for the bidder to follow through with the deal.

Most bidders still like to keep all their options open during the M&A process. They want to learn more about the target as they go along, and then make a decision at the last minute. Bidders are worried about spending time and money on a deal they will not complete. Therefore, they may try to elicit some assurance that the seller will actually sell to them and will not just shop their bid around. Therefore, a buyer may seek some coverage of expenses from the seller in order to make a bid. Likewise, the target may look for coverage of its expenses from the bidder to provide incentive for complying with the bidder's often onerous due diligence requirements in the course of negotiating a transaction. Satisfaction of such a request is often difficult to obtain.

Specific performance is a similar issue that gets discussed quite a bit in M&A transactions. The other side of that discussion is whether there is going to be a walk-away fee for either party.

Sellers Issues: Process

On the sell side, many corporate directors are still concerned about their process in considering an M&A transaction. The *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009), decision of the Delaware Supreme Court in March 2009 cleared the air considerably in this area. In *Lyondell*, the Delaware Supreme Court, in an *en banc* decision reversing a Chancery Court decision, rejected post-merger stockholder class action claims that independent directors failed to act in good faith in selling the company after only a week of negotiations with a single bidder, even accepting the plaintiff's allegations that the directors did nothing to prepare for an offer that might be expected from a recent purchaser of an 8 percent block and did not even consider conducting a market check before entering into a merger agreement (at a "blow-out" premium price) containing a no-shop provision (with a fiduciary out) and a 3 percent break-up fee. In *Lyondell*, the plaintiff alleged that the defendant directors failed to act in good faith in conducting the sale of Lyondell to an unaffiliated third party, which would have precluded exculpation under Lyondell's Delaware General Corporation Law § 102(b)(7) charter provision and left the directors exposed to personal liability (and possible monetary damages) for their conduct. In *Lyondell*, ten of eleven directors were disinterested and independent (the chief executive officer was the other director).

In reversing the Chancery Court and holding that summary judgment for the defendant directors should have been granted, the Delaware Supreme Court wrote that the vice chancellor had reviewed the record under a mistaken view of its holding in *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (Del. 1986), in three critical respects:

> First, the trial court imposed *Revlon* duties on the Lyondell directors before they either had decided to sell, or before the sale had become inevitable. Second, the court read *Revlon* and its progeny as creating a set of requirements that must be satisfied during the sale process. Third, the trial court equated an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith.

The Delaware Supreme Court noted that the Chancery Court had identified the following undisputed facts that would have supported summary judgment for the defendant directors:

> [T]he directors were "active, sophisticated, and generally aware of the value of the Company and the conditions of the markets in which the Company operated." They had reason to believe that no other bidders would emerge, given the price Basell [the buyer] had offered and the limited universe of companies that might be interested in acquiring Lyondell's unique assets. [Lyondell chief executive officer] Smith negotiated the price up from $40 to $48 per share—a price that Deutsche Bank [Lyondell's investment banker] opined was fair. Finally, no other acquiror expressed interest during the four months between the merger announcement and the stockholder vote.

The Delaware Supreme Court noted that the Chancery Court had focused on the following in finding the allegations of bad faith sufficient to preclude summary judgment:

> After the Schedule 13D was filed [by the buyer two months before the sale process began], the directors apparently took no action to prepare for a possible acquisition proposal. The merger was negotiated and finalized in less than one week, during which time the directors met for a total of only seven hours to consider the matter. The directors did not seriously press [the buyer] for a better price, nor did they conduct even a limited market check. Moreover, although the deal protections were not unusual or preclusive, the trial court was troubled by "the Board's decision to grant considerable protection to a deal that may not have been adequately vetted under *Revlon*."
>
> The trial court found the directors' failure to act during the two months after the filing of the Basell Schedule 13D critical to its analysis of their good faith. The court

> pointedly referred to the directors' "two months of slothful indifference despite knowing that the Company was in play," and the fact that they "languidly awaited overtures from potential suitors..." In the end, the trial court found that it was this "failing" that warranted denial of their motion for summary judgment.

The Delaware Supreme Court then explained why these factors were not determinative under a proper application of *Revlon* in relation to the applicable good faith standards:

> The problem with the trial court's analysis is that *Revlon* duties do not arise simply because a company is "in play." The duty to seek the best available price applies only when a company embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control. Basell's [the buyer] Schedule 13D did put the Lyondell directors, and the market in general, on notice that Basell was interested in acquiring Lyondell. The directors responded by promptly holding a special meeting to consider whether Lyondell should take any action. The directors decided that they would neither put the company up for sale nor institute defensive measures to fend off a possible hostile offer. Instead, they decided to take a "wait and see" approach. That decision was an entirely appropriate exercise of the directors' business judgment. The time for action under *Revlon* did not begin until July 10, 2007, when the directors began negotiating the sale of Lyondell.
>
> The Court of Chancery focused on the directors' two months of inaction, when it should have focused on the one week during which they considered Basell's offer. During that one week, the directors met several times; their CEO tried to negotiate better terms; they evaluated Lyondell's value, the price offered and the likelihood of obtaining a better price; and then the directors approved the merger. The trial court acknowledged that the

directors' conduct during those seven days might not demonstrate anything more than lack of due care. But the court remained skeptical about the directors' good faith—at least on the present record. That lingering concern was based on the trial court's synthesis of the *Revlon* line of cases, which led it to the erroneous conclusion that directors must follow one of several courses of action to satisfy their *Revlon* duties.

There is only one *Revlon* duty—to "[get] the best price for the stockholders at a sale of the company." No court can tell directors exactly how to accomplish that goal, because they will be facing a unique combination of circumstances, many of which will be outside their control. As we noted in *Barkan v. Amsted Industrie, Inc.*, "there is no single blueprint that a board must follow to fulfill its duties." That said, our courts have highlighted both the positive and negative aspects of various boards' conduct under *Revlon*. The trial court drew several principles from those cases: directors must "engage actively in the sale process," and they must confirm that they have obtained the best available price either by conducting an auction, by conducting a market check, or by demonstrating "an impeccable knowledge of the market."

The Lyondell directors did not conduct an auction or a market check, and they did not satisfy the trial court that they had the "impeccable" market knowledge that the court believed was necessary to excuse their failure to pursue one of the first two alternatives. As a result, the Court of Chancery was unable to conclude that the directors had met their burden under *Revlon*. In evaluating the totality of the circumstances, even on this limited record, we would be inclined to hold otherwise. But we would not question the trial court's decision to seek additional evidence if the issue were whether the directors had exercised due care. Where, as here, the issue is whether the directors failed to act in good faith, the

analysis is very different, and the existing record mandates the entry of judgment in favor of the directors.

The Delaware Supreme Court's opinion should be read in its context of an opinion on a denial of a motion for summary judgment on post-merger damage claims where there were some uncontested facts in the record before the court (rather than a motion to dismiss where the facts alleged in the plaintiff's pleadings must be accepted as true). The opinion should also be read as a strong statement that the Delaware courts would give deference to the decision of disinterested and independent directors when faced with a perceived need to act quickly on a proposal from an unaffiliated, serious bidder that reasonably appears to the directors to be in the best interests of the stockholders. More specific lessons from the opinion are:

- *Revlon* duties do not arise until the board starts a negotiation to sell the company and do not arise simply because the board has facts that give the board reason to believe that a third party will make an acquisition proposal. In the Supreme Court's words: "Revlon duties do not arise simply because a company is 'in play.' The duty to seek the best available price applies only when a company embarks on a transaction...that will result in a change of control." *Revlon* does not require a board to obtain a valuation of the company, commence an auction, or implement defensive measures just because the company is "in play." A board can exercise its business judgment to "wait and see" when a Schedule 13D has been filed that suggests a bid for the company is reasonably to be expected.
- When the *Revlon* duties become applicable, there is no single blueprint a board must follow to satisfy its *Revlon* duties. In the words of the Delaware Supreme Court: no "court can tell directors exactly how to accomplish [the *Revlon* goal to get the best price for the company], because they will be facing a unique combination of circumstances." Because there are no mandated steps, directors' failure to take any specific steps cannot amount to the conscious disregard of duties required for a finding of bad faith.
- Since there are no specific steps a board must take to satisfy its *Revlon* duties, directors do not fail in their duty of good faith to the shareholders if they do not seek competing bids, when they have a

fairness opinion and reason to believe that no topping bid is likely, and instead try (albeit unsuccessfully) to extract a higher price from the bidder. The directors do not have to succeed in negotiating a post-signing market check. Rather, the Delaware Supreme Court said directors fail in their duty of good faith: "Only if [the directors] knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty. * * * Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the [Chancery Court's] inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price." While a flawed process may be enough for a breach of the duty of care, it is not enough to establish the "conscious disregard" of known fiduciary duties required for a lack of good faith. The Delaware Supreme Court's opinion does not measure the directors' conduct on a duty of care scale, although the Supreme Court did comment that it "would not question the trial court's decision to seek additional evidence if the issue were whether the directors had exercised due care."

- Directors do not breach their duty of good faith by agreeing to reasonable deal protection provisions in the absence of an auction.
- Concluding merger negotiations in a one-week period is not bad faith.

Preferred Stock Issues in M&A Transactions

Another hot-button M&A-related litigation issue arises when the corporation has outstanding preferred stock whose holders may have interests different from the holders of common stock. As valuations have gone down, when you sell a company the common stock often gets wiped out or is almost wiped out, and the preferred stockholders may want an early exit because they can still recover all or a substantial part of their investment because of their liquidation preference. However, the common stockholders do not have much of an incentive to let the transaction go through.

In such a scenario, the preferred stockholders will essentially say, "We want our money back, and we do not care about what is left for the common

stockholders." However, the board of directors represents all of the shareholders. In representing all of the shareholders, the directors' fiduciary duty really runs to the common shareholders—the preferred shareholders are protected by their contracts. A preferred stock designation is really a contract, and preferred stockholders have certain contractual rights. Consequently, in these conflict situations, the directors may be beholden to the preferred stockholders, but they are charged with protecting the common stockholders. How directors should resolve those conflicts is a matter the courts are focusing on, as illustrated in the case *In re Trados Incorporated Shareholder Litigation*, 2009 WL 2225958 (Del.Ch. 2009).

In *Trados*, the plaintiff alleged that the Trados board breached its duty of loyalty by improperly favoring the interests of the preferred stockholders in approving a merger in which the preferred stockholders and management would receive all of the merger consideration, and the common stockholders would receive nothing. The plaintiff was a common stockholder who contended that a majority of the board lacked independence when approving the merger, because a majority of the directors had employment or ownership relationships with the preferred stockholders, and depended on them for their livelihood. Because of this lack of independence, the directors improperly favored the interests of the preferred stockholders. The court held that the plaintiff sufficiently rebutted the presumption of the business judgment rule, which protects the business decisions made by informed and independent directors. Essentially, if the directors made an informed decision in good faith that their decision was in the best interests of the company, the business judgment rule will protect the directors against breach of fiduciary duty claims. In the *Trados* case, the plaintiffs argued that the directors personally benefitted from the merger, were not able to make an independent decision, and should not have the protection of the business judgment rule. The court agreed with the plaintiffs, and therefore, the burden shifted to the defendants to demonstrate the entire fairness of the transaction. The court ultimately denied the defendants' motion to dismiss the case.

Since the directors have a duty to protect the common stockholders' interest when there is a conflict with the interests of the preferred stockholders, directors should endeavor to keep evidence that they discussed, considered, and weighed the options reasonably available to the corporation.

Duties to Creditors

One issue we expected to be looming is fiduciary duties to creditors. The Delaware courts have been emphatic in saying that the directors' duty runs solely to the corporation and its shareholders, and when a corporation is insolvent, there is not a fiduciary duty to the creditors. The issue of creditor rights to sue directors for breach of fiduciary duty was resolved (at least of Delaware corporations) in *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007). In *Gheewalla*, the Delaware Supreme Court held "that the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors," but the creditors of an insolvent corporation may bring a derivative action on behalf of the corporation against its directors. What this means is that the directors can take a business risk that, in their business judgment, may benefit the corporation, and the creditors may lose in the process.

Looking to the Future

Many people are concerned about the effect on M&A deals of possible changes in the tax law (i.e., are tax rates going to go up next year?). Another concern is whether antitrust enforcement is going to be more rigorous under the Obama Administration, which could make it harder to do deals.

Further, we may have more rigorous Securities and Exchange Commission review of transactions and related disclosure documents, which could also make it slower and more expensive to get deals done. Recent financial industry scandals, such as the Bernie Madoff case, have put more focus on the Securities and Exchange Commission's enforcement activities, which is going to filter into the commission's review of corporate transactions. These enforcement issues are going to affect the attitude of staff members in dealing with routine corporate transactions; many dealmakers are going to have a more suspicious mindset, and that is going to slow down deals and make the M&A process more expensive.

The big event this year has been the drying up of funds in the credit markets, and the Obama Administration's continuation of the Bush

policies of putting money into the marketplace in an attempt to increase liquidity. There has been some success in that process, which augurs well for 2010.

Related Resources

Byron F. Egan, *Acquisition Agreement Issues*, Penn State Law and City Bar Center for Continuing Legal Education, New York City Bar, Sixth Annual Institute on Corporate, Securities, and Related Aspects of Mergers and Acquisitions, New York, New York, September 25, 2009, www.jw.com/site/jsp/publicationinfo.jsp?id=1244.

Byron F. Egan, *Rule of Law or Rule of Awe: Fiduciary Duties in M&A Transactions*, University of Texas School of Law 2009 Mergers and Acquisitions Institute, Dallas, Texas, October 16, 2009, www.jw.com/site/jsp/publicationinfo.jsp?id=1263.

Byron F. Egan, *Responsibilities of Attorneys and Other M&A Professionals after the Sarbanes-Oxley Act*, American Bar Association Fourteenth Annual National Institute on Negotiating Business Acquisitions, New Orleans, Louisiana, November 13, 2009, www.jw.com/site/jsp/publicationinfo.jsp?id=1274.

Byron F. Egan is a partner with Jackson Walker L.L.P. and is engaged in corporate, partnership, securities, mergers and acquisitions, and financing practice. He has extensive experience in business entity formation and governance matters, mergers and acquisitions, and financing transactions in a wide variety of industries, including energy, financial, and technology. In addition to handling transactions, he advises boards of directors and their audit, compensation, and special committees with respect to fiduciary duty, the Sarbanes-Oxley Act, special investigation, and other issues.

Mr. Egan is senior vice chair and chair of the executive council of the mergers and acquisitions committee of the American Bar Association, and served as co-chair of its asset acquisition agreement task force. He is a member of the American Law Institute and is a former chairman of the Texas Business Law Foundation, of which he is currently a director and executive committee member. He is also a former chairman of the business law section of the State Bar of Texas and former chairman of that section's corporation law committee. He is also a life fellow of the Texas Bar Foundation.

For more than ten years, Mr. Egan has been listed in The Best Lawyers in America *under corporate, mergers and acquisitions, or securities Law. He won the Burton Award for Legal Achievement in 2005, 2006, 2008, and 2009. He has been recognized as one of the top corporate and mergers and acquisitions lawyers in Texas by a number of publications, including* Corporate Counsel Magazine, Texas Lawyer, Texas Monthly, The M&A Journal, *and* Who's Who Legal, *which most recently included him as one of the 2009 International Who's Who of Corporate Governance Lawyers. In 2009, Mr. Egan's paper titled "Director Duties: Process and Proof" was awarded the Franklin Jones Outstanding CLE Article Award, and an earlier version of the article received the Award for the Most Requested Article in the Last Five Years by the State Bar corporate counsel section. He is a frequent author and lecturer regarding mergers and acquisitions, corporations, partnerships, limited liability companies, securities laws, and financing techniques*

Mr. Egan earned his B.A. from the University of Texas at Austin and his J.D. from the University of Texas School of Law. After law school, he served as a law clerk for Judge Irving L. Goldberg on the U.S. Court of Appeals for the Fifth Circuit.

Appendices

Appendix A: "Summary of Certain M&A Nuggets" **114**

Appendix B: "Egan on Entities" **160**

APPENDIX A

"SUMMARY OF CERTAIN M&A NUGGETS"

The M&A Nuggets set forth below were derived from the following papers by Byron F. Egan:

- "*Egan's M&A Nuggets*," prepared for the Dallas Bar Association Mergers & Acquisitions Section's Fifth Annual M&A Nugget-Palooza on October 13, 2009, available at www.jw.com/site/jsp/publicationinfo.jsp?id=1265 ("*Egan's M&A Nuggets*").

- "*Rule of Law or Rule of Awe: Fiduciary Duties in M&A Transactions*," prepared for the UT School of Law 2009 Mergers and Acquisitions Institute on October 16, 2009 and available at www.jw.com/site/jsp/publicationinfo.jsp?id=1263 ("*Egan's Fiduciary Duties*").

1. What is *Revlon* and does it apply to private companies? [Egan's M&A Nuggets p. 79]

Under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), director fiduciary duties require robust director involvement in sale of control transactions to confirm that the stockholders are getting the best price reasonably available. Directors' fiduciary duties are applicable in the case of closely held corporations as well as corporations whose securities are publicly traded, although the conduct required to satisfy their fiduciary duties will be measured with reference to what is reasonable in the context. *See Optima International of Miami, Inc. v. WCI Steel, Inc.*, C.A. No. 3833-VCL (Del. Ch. June 27, 2008) (TRANSCRIPT); *Julian v. Eastern States Construction Service, Inc.* (Del. Ch. No. 1892-VCP July 8, 2008).

While Revlon involved a public company, its principles apply equally to private companies. Many fiduciary duty cases in both Delaware and Texas arise in the context of closely held corporations.[1]

[1] See generally *Flanary v. Mills*, 150 S.W.3d 785 (Tex. App.—Austin 2004, pet. denied) (examining situation where uncle and nephew incorporated 50%/50% owned roofing business, but never issued stock certificates or had board or shareholder meetings; uncle used corporation's banking account as his own, told nephew business doing poorly and

2. Does *Revlon* apply in Texas? [Egan's Fiduciary Duties pp. 4-10]

Yes and no. *Revlon* is a Delaware common law doctrine applicable only to corporations incorporated in Delaware. If there is a lawsuit in Texas involving the duties of directors of a Delaware corporation in the sale of control of the Delaware corporation, a Texas court would follow the "internal affairs doctrine" and apply Delaware law. "The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs,"[2] and "under the commerce clause a state has no interest in regulating the internal affairs of foreign corporations."[3] "

The internal affairs doctrine in Texas mandates that courts apply the law of a corporation's state of incorporation in adjudications regarding director fiduciary duties.[4] Delaware also subscribes to the internal affairs doctrine.

If the corporation was incorporated under the Texas Business Corporation Act or the Texas Business Organizations Code, a Texas court would apply Texas common law. *Revlon* is a Delaware case and not binding on a Texas court. Texas has its own body of precedent with respect to director fiduciary duties. In *Gearhart Industries, Inc. v. Smith International*, the Fifth Circuit sharply criticized the parties' arguments based on Delaware cases and failure to cite Texas jurisprudence in their briefing on director fiduciary duties:

> We are both surprised and inconvenienced by the circumstances that, despite their multitudinous and voluminous briefs and exhibits, neither plaintiffs nor defendants seriously attempt to analyze officers' and directors' fiduciary duties or the business judgment rule

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sent check to nephew for $7,500 as his share of proceeds of business for four years; the Court held uncle liable for breach of fiduciary duties that we would label loyalty and candor.)

[2] *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982).

[3] *McDermott, Inc. v. Lewis*, 531 A.2d 206, 217 (Del. 1987) (internal quotations omitted); Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33, 39 (Fall 2006).

[4] TBOC §§ 1.101-1.105; TBCA, art. 8.02; TMCLA art. 1302-1.03; *Hollis v. Hill*, 232 F.3d 460, 465 (5th Cir. 2000); *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984); *A. Copeland Enters., Inc. v. Guste*, 706 F. Supp. 1283, 1288 (W.D. Tex. 1989).

> under *Texas* law. This is a particularity so in view of the authorities cited in their discussions of the business judgment rule: Smith and Gearhart argue back and forth over the applicability of the plethora of out-of-state cases they cite, yet they ignore the fact that we are obligated to decide these aspects of this case under Texas law.[5]

The Fifth Circuit stated in *Gearhart* that under Texas law "[t]hree broad duties stem from the fiduciary status of corporate directors; namely the duties of obedience, loyalty, and due care," and commented that (i) the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation, (ii) the duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation, and (iii) the duty of due care requires that a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances.[6] Good faith under *Gearhart* is an element of the duty of loyalty. *Gearhart* remains the seminal case for defining the fiduciary duties of directors in Texas, although there are subsequent cases that amplify *Gearhart* as they apply it in the context of lawsuits by the Federal Deposit Insurance Corporation ("*FDIC*") and the Resolution Trust Company ("*RTC*") arising out of failed financial institutions.[7]

While the *Revlon* duty to maximize shareholder values is not among the Texas fiduciary duties enumerated in *Gearhart* and there are no Texas cases articulating such a duty, *Revlon* is at its heart part of the duty of care, although in some cases the duty of loyalty (and its subset good faith) are implicated. *Gearhart* says Texas recognizes both of the duties of care and

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[5] *Gearhart*, 741 F.2d at 719 n.4.

[6] *Gearhart*, 741 F.2d at 719-21; *McCollum v. Dollar*, 213 S.W. 259, 260 (Tex. Comm'n App. 1919, holding approved); *see Landon v. S & H Mktg. Group, Inc.*, 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.) (quoting and repeating the summary of Texas fiduciary duty principles from *Gearhart*); *cf. In re Schmitz*, 285 S.W. 3d 451 (Tex. 2009) (Texas Supreme Court cited in note 33 on p. 457 as continuing to be authoritative *Cates v. Sparkman*, 11 S.W. 846 (Tex. 1889), a case upon which *Gearhart* opinion based, in saying that Texas courts defer to director business judgment and do not require a Board to take the highest bid).

[7] *Floyd v. Hefner*, No. H-03-5693, 2006 WL 2844245 (S.D. Tex. Sept. 29, 2006); *see FDIC v. Harrington*, 844 F. Supp. 300 (N.D. Tex. 1994).

loyalty, although it says Texas courts are reluctant to second guess the business judgment by independent directors.

3. Did *Lyondell* kill *Revlon*? [Egan's M&A Nuggets pp. 79-82]

Lyondell Supreme Court Holding. In *Lyondell Chemical Company v. Ryan*, 970 A.2d 235 (Del. 2009), the Delaware Supreme Court, in an *en banc* decision reversing a Chancery Court decision, rejected post-merger stockholder claims that independent directors failed to act in good faith in selling the company after only a week of negotiations with a single bidder, even accepting plaintiff's allegations that the directors did nothing to prepare for an offer which might be expected from a recent purchaser of an 8% block and did not even consider conducting a market check before entering into a merger agreement (at a "blow-out" premium price) containing a no-shop provision (with a fiduciary out) and a 3% break-up fee. In *Lyondell* the plaintiff alleged that the defendant directors failed to act in good faith in conducting the sale of Lyondell to an unaffiliated third party, which would have precluded exculpation under Lyondell's DGCL § 102(b)(7) charter provision and left the directors exposed to personal liability (and possible monetary damages) for their conduct. In *Lyondell* ten of eleven directors were disinterested and independent (the CEO was the other director).

The plaintiff in *Lyondell* claimed that the Board failed to adequately fulfill its duty of care under *Revlon* by (1) engaging in a hasty deliberative process that rendered the Board unable to inform itself as to the company's value or as to the propriety of the transaction, (2) failing to conduct a market check or to shop the company and (3) agreeing to unreasonable deal protection devices that served to discourage competing bids. In the Chancery Court the defendant directors' motion for summary judgment was partially denied, with the Chancery Court emphasizing that *Revlon* requires robust Board involvement in sale of control transactions to confirm that, even at arguably a "blowout" market premium, the stockholders are getting the best price reasonably available. The Chancery Court had determined that genuine issues of material fact existed as to (1) whether the independent directors engaged in a satisfactory sale process to acquire the highest available value for stockholders as required by *Revlon* and (2) whether the directors' decision to agree to typical deal protections was reasonable in view of the weakness in the process. In a case reminiscent of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) in that the Board acted quickly on a

merger proposal negotiated by an informed CEO without Board involvement, the Chancery Court found that the directors' conduct could implicate the good faith component of the duty of loyalty and that all of these procedural shortcomings could add up to an overall failure to act in good faith, an element of a Board's duty of loyalty, since the Board members appeared not to have become fully engaged in an active *Revlon* process.

In reversing and holding that summary judgment for the defendant directors should have been granted, the Delaware Supreme Court explained *Revlon* as follows:

> The duty to seek the best available price applies only when a company embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control.
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> * * *
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> There is only one *Revlon* duty—to "[get] the best price for the stockholders at a sale of the company." No court can tell directors exactly how to accomplish that goal, because they will be facing a unique combination of circumstances, many of which will be outside their control. "[T]here is no single blueprint that a board must follow to fulfill its duties."
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> The Lyondell directors did not conduct an auction or a market check, and they did not satisfy the trial court that they had the "impeccable" market knowledge that the court believed was necessary to excuse their failure to pursue one of the first two alternatives. As a result, the Court of Chancery was unable to conclude that the directors had met their burden under *Revlon*. In evaluating the totality of the circumstances, even on this limited record, we would be inclined to hold otherwise. But we would not question the trial court's decision to seek

additional evidence if the issue were whether the directors had exercised due care. Where, as here, the issue is whether the directors failed to act in good faith, the analysis is very different, and the existing record mandates the entry of judgment in favor of the directors.

As discussed above, bad faith will be found if a "fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." The trial court decided that the *Revlon* sale process must follow one of three courses, and that the Lyondell directors did not discharge that "known set of [*Revlon*] 'duties'." But, as noted, there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties. Thus, the directors' failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties. More importantly, there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties.

Directors' decisions must be reasonable, not perfect. "In the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties." * * * [I]f the directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty.

* * *

Viewing the record in this manner leads to only one possible conclusion. The Lyondell directors met several times to consider Basell's premium offer. They were generally aware of the value of their company and they knew the chemical company market. The directors solicited and followed the advice of their financial and

> legal advisors. They attempted to negotiate a higher offer even though all the evidence indicates that Basell had offered a "blowout" price. Finally, they approved the merger agreement, because "it was simply too good not to pass along [to the stockholders] for their consideration." We assume, as we must on summary judgment, that the Lyondell directors did absolutely nothing to prepare for Basell's offer, and that they did not even consider conducting a market check before agreeing to the merger. Even so, this record clearly establishes that the Lyondell directors did not breach their duty of loyalty by failing to act in good faith. In concluding otherwise, the Court of Chancery reversibly erred.

Lessons from *Lyondell*. Some lessons from the Supreme Court's opinion in *Lyondell* are:

- *Revlon* duties do not arise until the Board starts a negotiation to sell the company and do not arise simply because the Board has facts that give the Board reason to believe that a third party will make an acquisition proposal. The *Revlon* "duty to seek the best available price applies only when a company embarks on a transaction . . . that will result in a change of control." *Revlon* does not require a Board to obtain a valuation of the company, commence an auction or implement defensive measures just because the company is "in play." A Board can exercise its business judgment to "wait and see" when a Schedule 13D has been filed that suggests a bid for the company is reasonably to be expected.

- When the *Revlon* duties become applicable, there is no single blueprint that a Board must follow to satisfy its *Revlon* duties. In the words of the Supreme Court: no "court can tell directors exactly how to accomplish [the *Revlon* goal to get the best price for the company], because they will be facing a unique combination of circumstances." Because there are no mandated steps, directors' failure to take any specific steps cannot amount to the conscious disregard of duties required for a finding of bad faith.

- Since there are no specific steps a Board must take to satisfy its *Revlon* duties, directors do not fail in their duty of good faith to the shareholders if they do not seek competing bids, when they have a fairness opinion and reason to believe that no topping bid is likely, and instead try (albeit unsuccessfully) to extract a higher price from the bidder. The directors do not have to succeed in negotiating a post-signing market check. While a flawed process may be enough for a breach of the duty of care, it is not enough to establish the "conscious disregard" of known fiduciary duties required for a lack of good faith. The Supreme Court's opinion does not measure the directors' conduct on a duty of care scale, although the Supreme Court did comment that it "would not question the trial court's decision to seek additional evidence if the issue were whether the directors had exercised due care."

- Directors do not breach their duty of good faith by agreeing to reasonable deal protection provisions in the absence of an auction.

- Concluding merger negotiations in a one week period is not bad faith.

Lyondell was a post closing damage case and does not govern action to enjoin a merger. While *Lyondell* did clarify the requirements of *Revlon*, the holding in favor of the defendant directors was in the context of a post closing damage action against directors who had the benefit of a DGCL § 102(b)(7) provision which required plaintiff to establish that the directors acted in bad faith. In *Lyondell*, the Delaware Supreme Court commented that "we would not question the trial court's decision to seek additional evidence if the issue were whether the directors exercised due care." Chancellor Chandler did precisely that in *Police & Fire Retirement System of the City of Detroit v. Bernal*,[8] in which the plaintiff shareholder of Data Domain, Inc. moved for expedited proceedings in connection with its motion to enjoin certain provisions of the agreement and plan of merger between Data Domain and NetApp, Inc. In March 2009, the Data Domain Board had commenced discussions with NetApp regarding a potential business combination. On May 11, 2009, the Data Domain Board was informed during a meeting to continue discuss a combination with NetApp that EMC

[8] C.A. No. 4663-CC, 2009 WL 1873144 (Del. Ch. June 26, 2009).

Corporation wanted to meet with Data Domain. Although a meeting with EMC was scheduled for May 27, 2009, on May 20 Data Domain and NetApp entered into the Merger Agreement whereby Data Domain would be acquired by NetApp for a combination of cash and NetApp stock worth approximately $25 per Data Domain share.

The plaintiff in *Bernal* complained about the "deal protection mechanisms" in the merger agreement, including: (1) a "matching right" that gives NetApp five business days to revise its proposal in response to a proposal from a third party bidder; (2) a "no solicitation" clause that prevents Data Domain from soliciting the submission or announcement of another offer to acquire Data Domain; and (3) a termination fee. Further, the Board and executive officers of Data Domain entered into a voting agreement whereby they pledged to vote their 20% of Data Domain's outstanding shares in favor of the NetApp merger. Plaintiff argued that these measures locked up the deal between Data Domain and NetApp and dissuade interested parties from making an offer for the company. Plaintiff further alleged that Data Domain's officers and directors would receive benefits separate and apart from Data Domain's other shareholders, including: (1) assumption and conversion of their Data Domain options, (2) indemnification from liability for matters arising from the completion of the merger, and (3) for certain individuals, positions with the company after the merger.

On June 1, EMC launched an all cash tender offer for Data Domain at a tender price of $30 per share. Then, on June 3, NetApp increased the cash component of the merger consideration by $5, raising the overall value of its offer to $30 per share, and Data Domain's Board agreed to the revised offer. The Data Domain Board stated that it was unable to negotiate with EMC because of the deal protection provisions of the merger agreement, and that if it failed to reject the EMC bid, Data Domain would be at risk of losing the NetApp transaction.

Plaintiff contended that Data Domain's directors violated their *Revlon* duties in the context of a sale of control of the company by failing to take any steps to secure the best price reasonably available, by granting preclusive deal protection measures that deter any other bidders, and by failing to inform themselves about the possibilities for greater value to be obtained for Data Domain shareholders through the EMC bid.

In holding that plaintiff had stated a sufficiently *colorable* claim to justify proceeding on an expedited schedule, the Chancellor wrote in *Bernal*:

> It is well established that there is no blueprint that a board must follow to fulfill its duties in a change of control transaction. The board, however, must exercise its duties in service of obtaining the maximum price reasonably available for the company. Plaintiff has alleged facts that state a colorable claim that the Data Domain board is favoring one bidder over others, thereby deterring bids from third parties that could provide greater value to Data Domain shareholders. Moreover, on a motion for a preliminary injunction, the plaintiff does not have to overcome the hurdle of an exculpatory provision that, as permitted by 8 *Del. C.* § 102(b)(7), exculpates directors from personal liability for *monetary damages* for certain breaches of fiduciary duty.
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> Plaintiff has also established a sufficient likelihood of irreparable injury. Plaintiff alleges that the deal protection measures in the Merger Agreement are currently having an adverse impact on Data Domain shareholders by deterring potential bidders, including EMC. Harm resulting from such deterrence is incalculable. Moreover, it would be impossible to "unscramble the eggs" by attempting to unwind the merger once it has been completed. Defendants argue that plaintiff is not threatened with irreparable harm because the shareholders will have an opportunity to vote on the NetApp merger. The opportunity for a shareholder vote sometime in the future, however, does not address the alleged current deterrent effect of the deal protection measures.
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> **Finally, I note that injunctive relief may be the only relief reasonably available to shareholders for certain breaches of fiduciary duty in connection with a sale of control transaction, particularly where the company has adopted a provision exculpating its directors from personal liability for monetary damages for breaches**

of the duty of care. As explained in Lyondell Chemical Co. v. Ryan, a plaintiff faces a significant burden in showing that a board acted in bad faith by failing to reasonably inform themselves or otherwise carry out their fiduciary duties in a sale of control. Thus, in cases such as this one, the shareholders' only realistic remedy for certain breaches of fiduciary duty in connection with a sale of control transaction may be injunctive relief.

Not second guess independent business judgment. Shortly after *Bernal*, in *Wayne County Employees' Ret. Sys. v. Corti*,[9] the Court of Chancery dismissed all claims brought by a former stockholder of video game maker Activision, Inc. in connection with its combination with Vivendi Games, Inc., whereby Vivendi became the majority stockholder in the combined entity. The Plaintiff challenged the conduct of the Activision directors in negotiating and approving the combination, alleging that two Activision inside directors controlled both the sale process and Activision's advisors and favored their personal interests above the interests of Activision's other stockholders. The plaintiff further alleged that the remaining directors breached their fiduciary duties by allowing the insiders to control the negotiations and the advisors and by failing to obtain a "control premium" for stockholders.

The Chancery Court determined that although management entrenchment can be a concern, the plaintiff had made no factual allegations that the insiders were motivated by entrenchment. Importantly, Vivendi assumed from the start of negotiations that the insiders would retain positions in the new company, and there were no allegations that there was a bidder threatening to take over Activision and replace management or that the insiders would be removed from their positions if Activision did not pursue a transaction with Vivendi. Nor had the plaintiff alleged facts sufficient to support its allegation that the insiders favored their own "interests in creating and reigning over [a] combined empire." To support such a claim, a plaintiff would have to show that the insiders' primary purpose for pursuing the transaction was a desire to increase the size of the company for the insiders' benefit, which would be a difficult showing to make. Largely for these reasons, the Court also determined that the remaining

[9] C.A. No. 3534-CC (Del. Ch. July 24, 2009).

directors had not abdicated their duties in permitting the insiders to be involved actively in the negotiations.

The remaining fiduciary duty claims turned on whether the directors had failed to act in good faith (as defined in *Lyondell*) by having "knowingly and completely failed to undertake their responsibilities" to obtain the best sale price. The Board had formed a Special Committee of outside directors to oversee the sale process, and the Board and the Special Committee along with its financial advisor met several times in the month leading up to the transaction, the Board regularly evaluated financial reports and analyses, and no alternative bidder emerged in the roughly seven-month period between the signing and closing of the transaction. Further, prior to approving the transaction, the Activision Board received a fairness opinion from its financial advisor, which had been advising the Board throughout this process. Given that no "blueprint" must be followed in a sale of control, the Court said that there is no requirement that a Board probe for alternatives, as the plaintiff had argued.

Likewise, there is no requirement that the Board obtain separate consideration identified as a "control premium." Rather, any "control premium" received by the selling company would be included in the consideration received by the stockholders in exchange for what is given to the acquirer, including voting control. Focusing on the Board's decision-making process rather than making an independent judgment of whether consideration received was adequate, the Court concluded that the plaintiff's allegations were merely veiled attacks on the adequacy of the price obtained in the sale of control, and that if directors fulfill their fiduciary duties in the sale of control process, the Court will "not second guess the business decision of the Board."

Finally and although conceding that under DGCL § 122(17) a corporation may renounce in its certificate of incorporation any interest or expectancy in a corporate opportunity, the plaintiff sought a declaration that the DGCL § 122(17) provision in the combined company's certificate of incorporation relating to corporate opportunities was invalid and unenforceable because it did not specify the renounced corporate opportunities, as required by DGCL § 122(17). The Court determined that this claim was not ripe for adjudication because the mere existence of the charter provision did not

pose sufficient harm to stockholders to outweigh concerns associated with rendering a hypothetical opinion.

4. Does *Revlon* apply to asset sales? [Egan's M&A Nuggets p. 79]

No because a sale of assets does not involve a change in control of the corporation, but directors still have a duty to maximize value. *Revlon* does not apply to a sale of assets, including the sale of a subsidiary, because the transaction does not involve a sale of control of the Company. Although *Revlon* is not applicable, the directors' fiduciary duty of care still requires directors to use informed business judgment to maximize value in a sale of assets. *See McPadden v. Sidhu*, 964 A.2d 1262 (Del. Ch. 2008).

5. Do Creditors Have Rights in M&A Transactions? [Egan's M&A Nuggets p. 82]

While creditors' power over the corporate governance of a solvent company is limited to the rights given to them by their contracts, their interest in business combinations expands as the company approaches insolvency and the creditors become more concerned that the company maximize the value received in order to increase the likelihood that they will be paid in full. In *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 930 A2d 92, 94 (Del. 2007) the Delaware Supreme Court held "that the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors," but the creditors of an insolvent corporation may bring a derivative action on behalf of the corporation against its directors. *See Torch Liquidating Trust v. Stockstill*, 561 F.3d 377 (5th Cir.2009) (the Fifth Circuit applying Delaware law followed *Gheewalla* in derivative action by liquidating trust for an insolvent closely held Delaware corporation against its officers and directors alleging breach of their fiduciary duties in making misleading statements about the corporation's financial health that induced trade creditors to deal with it, but dismissed claims because plaintiff failed to allege how their statements damaged the corporation as opposed to the creditors); *cf. Trenwick America Litigation Trust v. Ernst & Young LLP, et al.*, 906 A.2d 168 (Del. Ch. 2006) (Delaware Chancery Court held that "put simply, under Delaware law, 'deepening insolvency' is no more of a cause of action when a firm is insolvent than a cause of action for 'shallowing

profitability' would be when a firm is solvent"); *Floyd v. Hefner*, 2006 WL 2844245 (S.D. Tex. 2006) (no creditor standing under Texas law to bring claims against directors of insolvent corporation until it has ceased to do business and must operate as trust fund for the benefit of creditors).

6. Corporation has common and preferred stock outstanding and is on lip of insolvency with net worth likely less than liquidation preference of preferred stock. Can Board dominated by preferred approve a merger whose consideration almost covers liquidation preference of preferred stock and leaves nothing for common stock? [Egan's Fiduciary Duties pp. 39-44]

A corporation's common and preferred stockholders may have conflicting interests, particularly if its financial condition deteriorates as in the context of a recapitalization or sale of the business.[10] For example, *Equity-Linked Investors, L.P. v. Adams*[11] involved a conflict between the interests of the common stockholders and those of the preferred stockholders of Genta Corporation. Genta was on the "lip of insolvency" and in liquidation likely would have been worth substantially less than the $30,000,000 liquidation preference held by the preferred stock. Rather than preserving what capital remained for distribution to the preferred stock in an immediate liquidation, the Genta Board pursued means to keep the enterprise in operation based in part on a belief that it had several promising technologies in the research stage that, if brought to market, could be extremely valuable. The Chancery Court held that, although the "board action was taken for the benefit largely of the common stock" and the holders of the preferred stock disapproved, it did not constitute a breach of duty to the preferred. The Court based its decision in part on the fact that the special protections afforded to the preferred were contractual in nature. The Court held that where the "foreseeable financial effects of a board decision may importantly fall upon creditors as well as holders of common stock, as where the corporation is in the vicinity of insolvency, an independent board may consider impacts upon all corporate constituencies in exercising its good faith business judgment for benefit of the corporation." The Court essentially allowed the Genta Board to focus on maximizing the corporation's long-term wealth

[10] Mark A. Morton, *First Principles for Addressing the Competing Interests of Common and Preferred Stockholders in an M&A Transaction* (Sept. 2009).
[11] 705 A.2d 1040 (Del. Ch. 1997).

creating capacity even where the business judgment of another Board might have led Genta to liquidate. The Court emphasized, among other things, that the Genta Board (i) was independent; (ii) acted in good faith; (iii) was well-informed regarding the available alternatives to the financial restructuring plan it undertook; and (iv) acted in a manner reasonably related to its business plan. The Court also noted that Genta "would have been" insolvent if the liquidation preference of the preferred stock had been treated as a liability, which indicates that the Court did not consider the liquidation preference of the preferred stock as debt.[12]

Board ties to one class of stock can result in judicial scrutiny. For example, in *In re Trados Incorporated Shareholder Litigation*,[13] the plaintiff alleged that, in determining to pursue a merger and in approving a merger pursuant to which the preferred stockholders and management would receive all of the merger consideration and the common stockholders would receive nothing, the Trados Board breached its duty of loyalty by improperly favoring the interests of the preferred stockholders. The plaintiff, a common stockholder, contended that a majority of the Board was interested or lacked independence when approving the merger and that the conflicted directors improperly favored the interests of the preferred stockholders. Based on the plaintiff's allegations that a majority of the directors had employment or ownership relationships with the preferred stockholders and depended on the preferred stockholders for their livelihood, the Court held that the plaintiff sufficiently rebutted the presumption of the business judgment rule (and therefore the burden would shift to the defendants to demonstrate the entire fairness of the transaction) and denied the motion to dismiss. The Chancery Court explained its decision as follows:

> Plaintiff contends that this transaction was undertaken at the behest of certain preferred stockholders that desired a transaction that would trigger their large liquidation preference and allow them to exit their investment in

[12] *Quadrangle Offshore (Cayman) LLC v. Kenetech Corporation*, 1999 WL 893575 (Del. Ch.), aff'd 751 A. 2d 878 (Del. Supr. 2000) ("As with all contracts, however, the rights and obligations expressed in the certificate [of designation] are protected by an implied covenant of good faith and fair dealing.. . . [which] plays a narrow but necessary role, prohibiting opportunistic conduct that defeats the purpose of the agreement and runs counter to the justified expectations of the other party.").

[13] 2009 Del. Ch. LEXIS 128 (Del. Ch. 2009).

Trados. Plaintiff alleges that the Trados board favored the interests of the preferred stockholders, either at the expense of the common stockholders or without properly considering the effect of the merger on the common stockholders. Specifically, plaintiff alleges that the four directors designated by preferred stockholders had other relationships with preferred stockholders and were incapable of exercising disinterested and independent business judgment. Plaintiff further alleges that the two Trados directors who were also employees of the Company received material personal benefits as a result of the merger and were therefore also incapable of exercising disinterested and independent business judgment.

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As explained below, plaintiff has alleged facts sufficient, at this preliminary stage, to demonstrate that at least a majority of the members of Trados' seven member board were unable to exercise independent and disinterested business judgment in deciding whether to approve the merger. Accordingly, I decline to dismiss the breach of fiduciary duty claims arising out of the board's approval of the merger.

* * *

Count I of the Complaint asserts a claim that the director defendants breached their fiduciary duty of loyalty to Trados' common stockholders by approving the merger. Plaintiff alleges that there was no need to sell Trados at the time because the Company was well-financed, profitable, and beating revenue projections. Further, plaintiff contends, "in approving the Merger, the Director Defendants never considered the interest of the common stockholders in continuing Trados as a going concern, even though they were obliged to give priority to that interest over the preferred stockholders' interest in exiting their investment."

Directors of Delaware corporations are protected in their decision-making by the business judgment rule, which "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." The rule reflects and promotes the role of the board of directors as the proper body to manage the business and affairs of the corporation.

The party challenging the directors' decision bears the burden of rebutting the presumption of the rule. If the presumption of the rule is not rebutted, then the Court will not second-guess the business decisions of the board. If the presumption of the rule is rebutted, then the burden of proving entire fairness shifts to the director defendants. A plaintiff can survive a motion to dismiss under Rule 12(b)(6) by pleading facts from which a reasonable inference can be drawn that a majority of the board was interested or lacked independence with respect to the relevant decision.

A director is interested in a transaction if "he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders" or if "a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders." The receipt of any benefit is not sufficient to cause a director to be interested in a transaction. Rather, the benefit received by the director and not shared with stockholders must be "of a sufficiently material importance, in the context of the director's economic circumstances, as to have made it improbable that the director could perform her fiduciary duties … without being influenced by her overriding personal interest…."

"Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." At this stage, a lack of independence can be shown by pleading

facts that support a reasonable inference that the director is beholden to a controlling person or "so under their influence that their discretion would be sterilized."

Plaintiff's theory of the case is based on the proposition that, for purposes of the merger, the preferred stockholders' interests diverged from the interests of the common stockholders. Plaintiff contends that the merger took place at the behest of certain preferred stockholders, who wanted to exit their investment. Defendants contend that plaintiff ignores the "obvious alignment" of the interest of the preferred and common stockholders in obtaining the highest price available for the company. Defendants assert that because the preferred stockholders would not receive their entire liquidation preference in the merger, they would benefit if a higher price were obtained for the Company. Even accepting this proposition as true, however, it is not the case that the interests of the preferred and common stockholders were aligned with respect to the decision of whether to pursue a sale of the company or continue to operate the Company without pursuing a transaction at the time.

The merger triggered the $57.9 million liquidation preference of the preferred stockholders, and the preferred stockholders received approximately $52 million dollars as a result of the merger. In contrast, the common stockholders received nothing as a result of the merger, and lost the ability to ever receive anything of value in the future for their ownership interest in Trados. It would not stretch reason to say that this is the worst possible outcome for the common stockholders. The common stockholders would certainly be no worse off had the merger not occurred.

Taking, as I must, the well-pleaded facts in the Complaint in the light most favorable to plaintiff, it is reasonable to infer that the common stockholders would have been able to receive some consideration for their Trados shares at

some point in the future had the merger not occurred. This inference is supported by plaintiffs allegations that the Company's performance had significantly improved and that the Company had secured additional capital through debt financing. Thus, it is reasonable to infer from the factual allegations in the Complaint that the interests of the preferred and common stockholders were not aligned with respect to the decision to pursue a transaction that would trigger the liquidation preference of the preferred and result in no consideration for the common stockholders.

Generally, the rights and preferences of preferred stock are contractual in nature. This Court has held that directors owe fiduciary duties to preferred stockholders as well as common stockholders where the right claimed by the preferred "is not to a preference as against the common stock but rather a right shared equally with the common." Where this is not the case, however, "generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, *etc.*, of preferred stock, where there is a conflict." Thus, in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders. As explained above, the factual allegations in the Complaint support a reasonable inference that the interests of the preferred and common stockholders diverged with respect to the decision of whether to pursue the merger. Given this reasonable inference, plaintiff can avoid dismissal if the Complaint contains well-pleaded facts that demonstrate that the director defendants were interested or lacked independence with respect to this decision.

> Plaintiff has alleged facts that support a reasonable inference that ... the four board designees of preferred stockholders, were interested in the decision to pursue the merger with SDL, which had the effect of triggering the large liquidation preference of the preferred stockholders and resulted in no consideration to the common stockholders for their common shares. Each of these four directors was designated to the Trados board by a holder of a significant number of preferred shares. While this, alone, may not be enough to rebut the presumption of the business judgment rule, plaintiff has alleged more. Plaintiff has alleged that ... each had an ownership or employment relationship with an entity that owned Trados preferred stock. ... Plaintiff further alleges that each of these directors was dependent on the preferred stockholders for their livelihood. As detailed above, each of these entities owned a significant number of Trados' preferred shares, and together these entities owned approximately 51% of Trados' outstanding preferred stock. The allegations of the ownership and other relationships of each of ... to preferred stockholders, combined with the fact that each was a board designee of one of these entities, is sufficient, under the plaintiff-friendly pleading standard on a motion to dismiss, to rebut the business judgment presumption with respect to the decision to approve the merger with SDL.

Similarly, in *Oliver v. Boston University*,[14] the Chancery Court found that the plaintiffs established a breach of the Board's duty of loyalty and required the defendant directors to demonstrate the entire fairness of the Board's allocation of merger consideration between holders of common and preferred stock. In *Oliver*, the Board was comprised of individuals tied to the preferred stock who treated the merger allocation negotiations with a "surprising degree of informality." Although representatives of all the preferred stockholders were involved in the negotiations, the Board took no steps (such as permitting a representative of the minority common stockholders to participate in negotiations on their behalf) "to ensure

[14] C.A. No. 16570, 2006 WL 1064169 (Del. Ch. Apr. 14, 2006).

fairness to the minority common shareholders." For that reason, the Court held that the defendants failed to carry their burden to demonstrate the fairness of the transaction to the holders of common stock.

The Board's duty of loyalty may be implicated if a majority of the directors own common stock and approve a transaction favoring the common stock over the preferred stock. In *Sullivan Money Mgmt., Inc. v. FLS Holdings, Inc.*,[15] the Court found that the plaintiffs established a claim for breach of the board's duty of loyalty when no independent agency or advisor was appointed to represent the interests of the preferred stockholders during merger negotiations. The plaintiffs alleged that the directors owned large amounts of common stock, that the interests of the common stockholders were in conflict with the interests of the preferred stock in effectuating the merger, and that the defendant directors failed to employ an independent representative to protect the interests of the preferred stock. Under those circumstances, the Court found that the burden shifted to the defendant directors to demonstrate the fairness of the transaction to the holders of preferred stock.

In each of these cases, the Court focused on the inherent conflict of a majority of the Board and the absence of appropriate procedural protections for the stockholders exposed to the potential abuses that may arise out of such conflict. These decisions suggest the use of a special committee of independent directors, a majority of minority stockholder vote, allowing a representative of the minority interest to participate directly in the negotiations concerning allocation, or other procedures to insulate the transaction from the Board conflict).

7. What is a MAC and can a buyer safely rely on a MAC in walking a deal that begins to look bad? [Egan's M&A Nuggets pp. 99-110]

3.15 No Material Adverse Change [Seller representation that gets brought down to Closing by closing condition that all Seller representations be correct at signing and at closing]

Since the date of the Balance Sheet, there has not been any material adverse change in the business, operations, prospects, assets, results of operations

[15] Del. Ch., C.A. No. 12731 (Nov. 20, 1992), *aff'd*, 628 A.2d 84 (Del. 1993).

or condition (financial or other) of Seller, and no event has occurred or circumstance exists that may result in such a material adverse change.

COMMENT

A seller may have several comments to this representation. First, the seller may resist the representation in its entirety on the basis that the buyer is buying assets, rather than stock. Second, if the seller is unsuccessful in eliminating the representation in its entirety, the seller might try to limit the representation by, for example, deleting certain portions of the representations, such as the reference to "prospects" on the basis that "prospects" is too vague. Third, the seller might try to specify a number of items that will not be deemed to constitute a material adverse change in the business, etc. of the seller even if they were to occur. In that regard, the seller might suggest the following "carve outs" be added to the end of Section 3.15:

> ; provided, however, that in no event shall any of the following constitute a material adverse change in the business, operations, prospects, assets, results of operations or condition of Seller: (i) any change resulting from conditions affecting the industry in which Seller operates or from changes in general business or economic conditions; (ii) any change resulting from the announcement or pendency of any of the transactions contemplated by this Agreement; and (iii) any change resulting from compliance by Seller with the terms of, or the taking of any action contemplated or permitted by, this Agreement.

The buyer, however, may resist the changes suggested by the seller on the basis that the buyer needs assurances that the business it is buying through its asset purchase has not suffered a material adverse change since the date of the most recent audited balance sheet of the seller. If the buyer agrees to one or more "carve outs" to the material adverse change provision, the buyer might want to specify a standard of proof with respect to the "carve outs" (*e.g.*, that (i) the only changes that will be excluded are those that are "proximately," "demonstrably" or "directly" caused by the particular circumstances described above, and (ii) with respect to any dispute

regarding whether a change was proximately caused by one of the circumstances described above, the seller shall have the burden of proof by a preponderance of the evidence).

Whether or not the general material adverse change provision remains in the agreement, counsel to the buyer may wish to specifically identify those changes in the business or assets that the buyer would regard as important enough to warrant not going ahead with the transaction. *See Esplanade Oil & Gas, Inc. v. Templeton Energy Income Corporation*, 889 F.2d 621 (5th Cir. 1989) ("adverse material change to the Properties" held to refer to the seller's right, title and interest to oil properties and not to a decline in the value of those properties resulting from a precipitous drop in the price of oil). *See also John Borders v. KRLB, Inc.*, 727 S.W.2d 357 (Tex. Ct. App. 1987) (material adverse change in the target's "business, operations, properties and other assets which would impair the operation of the radio station" held not to include a significant decline in "Arbitron ratings" of the target radio station, indicating that the target had lost one-half of its listening audience, because (i) the material adverse change provision did not specifically refer to a ratings decline, and (ii) a ratings decline was not within the scope of the material adverse change provision at issue). *See also*, Greenberg and Haddad, *The Material Adverse Change Clause: Careful Drafting Key, But Certain Concerns May Need To Be Addressed Elsewhere*, New York Law Journal (April 23, 2001) at S5, S14-S15, for a discussion regarding the uncertainties in the judicial application of material adverse change provisions.

In *In re IBP, Inc. Shareholders Litigation*, 787 A.2d 14 (Del. Ch. 2001) ("*IBP v. Tyson*"), the Delaware Chancery Court, applying New York law, granted IBP's request for specific performance of its merger agreement with Tyson and ordered Tyson to complete the merger. A central issue in the case involved application of the general no material adverse change provision included in the merger agreement. Section 5.10 of the merger agreement was a representation and warranty that IBP had not suffered a "Material Adverse Effect" since the "Balance Sheet Date" of December 25, 1999, except as set forth in the financial statements covered by the financial statement representation in the merger agreement or Schedule 5.10 of the merger agreement. Under the merger agreement, a "Material Adverse Effect" was defined as "any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect" ... "on the condition (financial or

otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as whole ..." While the Court's decision was based on a very fact specific analysis, the opinion focused on the information about IBP's difficulties that Tyson had gleaned through its negotiating and due diligence processes and Tyson's strategic objectives:

> These negotiating realities bear on the interpretation of § 5.10 and suggest that the contractual language must be read in the larger context in which the parties were transacting. To a short-term speculator, the failure of a company to meet analysts' projected earnings for a quarter could be highly material. Such a failure is less important to an acquiror who seeks to purchase the company as part of a long-term strategy. To such an acquiror, the important thing is whether the company has suffered a Material Adverse Effect in its business or results of operations that is consequential to the company's earnings power over a commercially reasonable period, which one would think would be measured in years rather than months. It is odd to think that a strategic buyer would view a short-term blip in earnings as material, so long as the target's earnings-generating potential is not materially affected by that blip or the blip's cause.
>
> * * *
>
> Practical reasons lead me to conclude that a New York court would incline toward the view that a buyer ought to have to make a strong showing to invoke a Material Adverse Effect exception to its obligation to close. Merger contracts are heavily negotiated and cover a large number of specific risks explicitly. As a result, even where a Material Adverse Effect condition is as broadly written as the one in the Merger Agreement, that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse

> Effect should be material when viewed from the longer-term perspective of a reasonable acquiror. In this regard, it is worth noting that IBP never provided Tyson with *quarterly* projections.
>
> * * *
>
> Therefore, I conclude that Tyson has not demonstrated a breach of § 5.10. I admit to reaching this conclusion with less than the optimal amount of confidence. The record evidence is not of the type that permits certainty. *Id.* at 35-39.

IBP v. Tyson is affecting how attorneys and courts think about material adverse change provisions. In *Frontier Oil Corp. v. Holly Corp.*, CA No. 20502 2005, WL 1039027, (Del. Ch. Apr. 29, 2005), the Delaware Court of Chancery in reviewing Holly's claim that Frontier had breached its representation in Section 4.8 of the Merger Agreement that "there are no actions . . . threatened against Frontier . . . other than those which would not have or reasonably could be expected to have a Frontier Material Adverse Effect," the Court placed the burden of establishing a Material Adverse Effect with respect to Frontier on Holly. The Court noted that while the notion of a Material Adverse Effect "is imprecise and varies both with the context of the transaction and its parties and with the words chosen by the parties," the drafters of the Merger Agreement had the benefit of the analysis set forth in *IBP v. Tyson*, which discussed whether an acquiring party in a merger could invoke a Material Adverse Effect to escape from the transaction. With respect to the Merger Agreement's definition of Material Adverse Effect, the Court commented:

> It would be neither original nor perceptive to observe that defining a "Material Adverse Effect" as a "material adverse effect" is not especially helpful. Moreover, the definition chosen by the parties emphasizes the need for forward-looking analysis; that is especially true because the parties, through the drafting changes designed to assuage Holly's concerns about the threatened Beverly Hills Litigation added the "would not reasonably be expected to have" an MAE standard to the scope of inquiry regarding

> threatened litigation and the term "prospects" to the list of "the business, assets and liabilities . . . results of operations [and] condition" in the definition of an MAE.

The Court also commented in a footnote:

> The parties used "would," not "could" or "might." "Would" connotes a greater degree (although quantification is difficult) of likelihood than "could" or "might," which would have suggested a stronger element of speculation (or a lesser probability of adverse consequences).

The Court noted that the Court in *IBP v. Tyson*, applying New York law, found that a buyer would be required to make a strong showing to invoke a Material Adverse Effect exception, namely, a showing that the complained of event would have a material effect on the long-term earnings potential of the target company. The Court wrote that in this context "it may be more useful to consider the standard drawn from *IBP* as one designed to protect a merger partner from the existence of unknown (or undisclosed) factors that would justify an exit from the transaction."

While noting that *IBP v. Tyson* applied New York law, the Court found no reason why Delaware law should prescribe a different approach. The Court found that since, under *IBP v. Tyson* a defendant seeking to avoid performance of a contract due to its counterparty's breach of warranty must assert that breach as an affirmative defense, it followed that the same defendant pursuing an affirmative counter-claim would be charged with the burden as well.

Whether the California litigation was, or was reasonably likely to have, a Material Adverse Effect was, in the Court's view, an issue with quantitative and qualitative aspects. Since Holly presented no evidence, scientific or otherwise, relating to the substance of the California plaintiffs' claims and how the California proceedings should play out, the Court found that Holly failed to meet its burden.

With respect to Holly's claims that the defense costs alone of the litigation constituted a Material Adverse Effect, Holly variously had estimated the

defense costs of the litigation as ranging from $200,000 per month to $25 million to $40 million and then from $40 million to $50 million. Frontier produced separate estimates suggesting that the defense costs would be in the range of $11 million to $13 million. The Court found that a reasonable estimate of the costs would be in the range of $15 million to $20 million, and concluded that this range of costs alone did not constitute a Material Adverse Effect in a deal worth hundreds of millions.

Hexion Specialty Chemicals, Inc. v. Huntsman Corp., C.A. No. 3841-VCL (Del. Ch. Sept. 29, 2008), is the latest example of the reluctance of Delaware courts to find a Material Adverse Effect to have occurred in the context of a merger agreement. After a competitive auction, the buyer (Hexion) induced the target (Huntsman) to terminate target's merger agreement with another party and to enter into a merger agreement with it. While the parties were engaged in obtaining the necessary regulatory approvals, the target reported several disappointing quarterly results, missing the numbers it projected at the time the deal was signed. The buyer began exploring options for extricating the target from the transaction, first claiming that target had suffered a Material Adverse Effect and then obtaining an opinion that the combined entity would be insolvent, which caused buyer's lenders to try to get out of their commitment to fund the purchase price.

Because the buyer was eager to be the winning bidder in a competitive bidding situation, it agreed to pay a substantially higher price than the competition and to commit to stringent deal terms that were more than usually favorable to target. The merger agreement contained no financing contingency and required buyer to use its "reasonable best efforts" to consummate the financing. In addition, the agreement expressly provided for uncapped damages in the case of a "knowing and intentional breach of any covenant" by buyer and for liquidated damages of $325 million if buyer otherwise breached its terms. The merger provides that a non-breaching party may obtain specific performance of the other party's covenants, but that target "shall not be entitled to enforce specifically the obligations of [buyer] to consummate the merger."

The narrowly tailored Material Adverse Effect clause read as follows:

> any occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or

> results of operations of the Company and its Subsidiaries, taken as a whole; provided, however, that in no event shall any of the following constitute a Company Material Adverse Effect: (A) any occurrence, condition, change, event or effect resulting from or relating to changes in general economic or financial market conditions, except in the event, and only to the extent, that such occurrence, condition, change, event or effect has had a disproportionate effect on the Company and its Subsidiaries, taken as a whole, as compared to other Persons engaged in the chemical industry; (B) any occurrence, condition, change, event or effect that affects the chemical industry generally (including changes in commodity prices, general market prices and regulatory changes affecting the chemical industry generally) except in the event, and only to the extent, that such occurrence, condition, change, event or effect has had a disproportionate effect on the Company and its Subsidiaries, taken as a whole, as compared to other Persons engaged in the chemical industry . . . .

After six days of trial, Vice Chancellor Lamb found that the target had not suffered a Material Adverse Effect, as defined in the merger agreement, and that the buyer had knowingly and intentionally breached numerous of its covenants under that agreement. Recognizing that there remained substantial obstacles to closing the transaction, some resulting from the current unsettled credit environment and some resulting from the course of action the buyer pursued in place of the continued good faith performance of the buyer's contractual obligations, the Court ordered specific performance of all of buyer's covenants and obligations (other than the ultimate obligation to close).

The Court rejected the buyer's argument that it could be excused from performing its freely undertaken contractual obligations simply because its board of directors concluded that the performance of those contractual obligations risked insolvency. Instead, it was the duty of the buyer's board of directors to explore the many available options for mitigating the risk of insolvency while causing the buyer to perform its contractual obligations in good faith. If, at closing, and despite the buyer's best efforts, financing had

not been available, the buyer could then have stood on its contract rights and faced no more than the contractually stipulated damages. The buyer and its parent, however, chose a different course.

In explaining its conclusion that target had not suffered a Material Adverse Effect, Vice Chancellor Lamb wrote:

> For the purpose of determining whether an MAE has occurred, changes in corporate fortune must be examined in the context in which the parties were transacting. In the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy. The important consideration therefore is whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months. A buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close. Many commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence. The ubiquitous material adverse effect clause should be seen as providing a "backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather [an adverse change] should be material when viewed from the longer-term perspective of a reasonable acquirer." This, of course, is not to say that evidence of a significant decline in earnings by the target corporation during the period after signing but prior to the time appointed for closing is irrelevant. Rather, it means that for such a decline to constitute a material adverse effect, poor earnings results must be expected to persist significantly into the future.

* * *

[A]bsent clear language to the contrary, the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract.

* * *

The issue then becomes what benchmark to use in examining changes in the results of business operations post-signing of the merger agreement—EBITDA or earnings per share. In the context of a cash acquisition, the use of earnings per share is problematic. Earnings per share is very much a function of the capital structure of a company, reflecting the effects of leverage. * * * What matters is the results of operation of the business. Because EBITDA is independent of capital structure, it is a better measure of the operational results of the business. Changes in [target's] fortunes will thus be examined through the lens of changes in EBITDA. This is, in any event, the metric the parties relied on most heavily in negotiating and modeling the transaction.

* * *

There is no question that [target's] results from the time of signing in July 2007 until the end of the first half of 2008 have been disappointing. [Target's] first-half 2008 EBITDA was down 19.9% year-over-year from its first-half 2007 EBITDA. And its second-half 2007 EBITDA was 22% below the projections [target] presented to bidders in June 2007 for the rest of the year.

Realizing, however, that these results, while disappointing, were not compelling as a basis to claim an MAE, [buyer] focused its arguments on [target's] repeated misses from its forecasts. * * * As of August 1, 2008, [target] management projected EBITDA for 2008 was $879 million, a 32% decrease from the forecast the year before. [buyer] points to these shortfalls from the 2007 projections and claims

> that [target's] failure to live up to its projections are key to the MAE analysis.
>
> But this cannot be so. Section 5.11(b) of the merger agreement explicitly disclaims any representation or warranty by [target] with respect to "any projections, forecasts or other estimates, plans or budgets of future revenues, expenses or expenditures, future results of operations . . ., future cash flows . . . or future financial condition . . . of [target] or any of its Subsidiaries . . . heretofore or hereafter delivered to or made available to [buyer or its affiliates] . . . ." The parties specifically allocated the risk to [buyer] that [target's] performance would not live up to management's expectations at the time. If [buyer] wanted the short-term forecasts of [target] warranted by [target], it could have negotiated for that. It could have tried to negotiate a lower base price and something akin to an earn-out, based not on [target's] post-closing performance but on its performance between signing and closing. Creative investment bankers and deal lawyers could have structured, at the agreement of the parties, any number of potential terms to shift to [target] some or all of the risk that [target] would fail to hit its forecast targets. But none of those things happened. Instead, [buyer] agreed that the contract contained no representation or warranty with respect to [target's] forecasts. To now allow the MAE analysis to hinge on [target's] failure to hit its forecast targets during the period leading up to closing would eviscerate, if not render altogether void, the meaning of section 5.11(b).

In *Genesco, Inc. vs. The Finish Line, Inc.*, No. 07-2137-II(III) (Tenn. Ch. Dec. 27, 2007), the buyer's allegations that a Material Adverse Effect had occurred were rejected and specific performance of the merger agreement was ordered. Within two months after the merger agreement was signed, it became apparent that Genesco's earnings would fall significantly short of projections. After Genesco's stockholders voted to approve the merger and Genesco demanded a closing, buyer refused to proceed. Genesco's lawsuit seeking specific performance followed. Finish Line asserted, *inter alia*, that

the decline in Genesco's earnings constituted a "Material Adverse Effect, which was defined in the merger agreement as follows:

> "Company Material Adverse Effect" shall mean any event, circumstance, change or effect that, individually or in the aggregate, is materially adverse to the business, condition (financial or otherwise), assets, liabilities or results of operations of the Company and the Company Subsidiaries, taken as a whole; provided, however, that none of the following shall constitute, or shall be considered in determining whether there has occurred, and no event, circumstance, change or effect resulting from or arising out of any of the following shall constitute, a Company Material Adverse Effect: (A) the announcement of the execution of this Agreement or the pendency of consummation of the Merger (including the threatened or actual impact on relationships of the Company and the Company Subsidiaries with customers, vendors, suppliers, distributors, landlords or employees (including the threatened or actual termination, suspension, modification or reduction of such relationships)); (B) changes in the national or world economy or financial markets as a whole or changes in general economic conditions that affect the industries in which the Company and the Company Subsidiaries conduct their business, so long as such changes or conditions do not adversely affect the Company and the Company Subsidiaries, taken as a whole, in a materially disproportionate manner relative to other similarly situated participants in the industries or markets in which they operate; (C) any change in applicable Law, rule or regulation or GAAP or interpretation thereof after the date hereof, so long as such changes do not adversely affect the Company and the Company Subsidiaries, taken as a whole, in a materially disproportionate manner relative to other similarly situated participants in the industries or markets in which they operate; (D) the failure, in and of itself, of the Company to meet any published or internally prepared estimates of revenues, earnings or other financial

> projections, performance measures or operating statistics; provided, however, that the facts and circumstances underlying any such failure may, except as may be provided in subsection (A), (B), (C), (E), (F) and (G) of this definition, be considered in determining whether a Company Material Adverse Effect has occurred; (E) a decline in the price, or a change in the trading volume, of the Company Common Stock on the New York Stock Exchange ("NYSE") or the Chicago Stock Exchange ("CHX"); (F) compliance with the terms of, and taking any action required by, this Agreement, or taking or not taking any actions at the request of, or with the consent of, Parent; and (G) acts or omissions of Parent or Merger Sub after the date of this Agreement (other than actions or omissions specifically contemplated by this Agreement).

The Court held that a Material Adverse Effect had not occurred based on expert testimony that Genesco's performance decline was due to general economic conditions and, therefore, the exception set forth in subpart (B) above applied. *See* XIII Deal Points (The Newsletter of the ABA Bus. L. Sec. Committee on Negotiated Acquisitions) at 20-22 (Spring 2008).

For a discussion of the advisability of including a separate "no material adverse change" condition in the acquisition agreement, see the Comment to Section 7.1 under the caption "Desirability of Separate 'No Material Adverse Change' Condition." For a discussion of the implications of various methods of drafting a phrase such as "that may result in such a material adverse change" (which appears at the end of Section 3.15), see the introductory Comment to Section 3 under the caption "Considerations When Drafting 'Adverse Effect' Language in Representations."

The tragic events of September 11, 2001 have led to a focus on whether terrorism or war are among the class risks encompassed by a no material adverse change provision. In Warren S. de Weid, *The Impact of September 11 on M&A Transactions*, 5 The M&A Lawyer No. 5 (Oct. 2001), the author concluded that in the few deals surveyed the general practice was not to adopt specific language to deal with September 11 type risks, but discussed the issues and a few examples as follows:

Unless the parties view terrorism or war as a class of risk that should be treated differently from other general risks, general effects of terrorism or war should be treated in the merger agreement in the same way as other general changes or events. It should be recognized that the exceptions for general events or changes relating to the financial markets, the economy, or parties' stock prices are not intended to protect a party from party-specific impacts of terrorism or other catastrophes, such as physical damage to its facilities, financial loss, or loss of key personnel, nor would one normally expect a party to be protected against such impacts. If, as was the case with the September 11 attacks, entire industries may be adversely affected by a general event, an exception for general industry changes may protect a party, depending upon the precise formulation of the exception, and the factual context. But the scope of any of these exceptions is often ambiguous, leaving room for argument over whether a change is general or specific. Indeed, in order to avoid the problem that economic, financial or industry changes, while they may be general in nature, may have quite disparate impacts even on two similar companies in the same industry, it is not unusual to see language in the carve-out for general changes which provides that this carve-out does not apply to disproportionate impacts on the company that is the object of the clause.

In a few post-September 11 deals, the parties have addressed impacts of September 11, or of other acts of terrorism, war or armed conflict, in the MAC clause. A merger agreement between First Merchants Corporation and Lafayette Bancorporation dated October 14, 2001, expressly *excludes* from the definition of material adverse change "...events and conditions relating to the business and interest rate environment in general (*including consequences of the terrorist attack on the* United *States on September 11...*" (italics added). Since the italicized language is merely indicative of a type of event that may affect the

business and interest rate environment in general, it was really not necessary to include such language in the agreement, although perhaps the parties took comfort from dealing explicitly with the events of September 11.

A merger agreement between Reliant Resources, Inc., Reliant Energy Power Generation Merger Sub, Inc. and Orion Power Holdings, Inc. dated as of September 26, 2001 expressly *includes* certain terrorism related events within the definition of a "Material Adverse Effect":

"Material Adverse Effect" shall mean any change or event or effect that, individually or together with other changes, events and effects, is materially adverse to the business, assets or financial condition of the Company and its subsidiaries, taken as a whole, except for…(ii) changes or developments in national, regional, state or local electric transmission or distribution systems *except to the extent caused by a material worsening of current conditions caused by acts of terrorism or war (whether or not declared) occurring after the date of this Agreement which materially impair the Company's ability to conduct its operations except on a temporary basis*, (iii) changes or developments in financial or securities markets or the economy in *general except to the extent caused by a material worsening of current conditions caused by acts of terrorism or war (whether or not declared) occurring after the date of this Agreement…*" (italics added).

In this case, the italicized language creates two different types of exceptions to the provisions limiting the scope of the MAC clause. One exception (which is quite understandable) encompasses events that are materially adverse to the target and affect the target company specifically, e.g., by disrupting state or local transmission or distribution systems (although the clause also addresses changes that are much broader, and that affect national power systems, and presumably would affect the target company only as one of many other power companies). The other exception carves out the exclusions from the

MAC clause changes in markets or the economy to the extent caused by terrorism or war, giving the buyer the right in certain circumstances not to close because of general changes due to terrorism or war. However the buyer must accept the risk of other general changes in the securities markets or the economy.

There are a number of interpretive and probative issues with the Reliant-type clause. If the buyer seeks to invoke the clause, the buyer must prove: (a) that *terrorism* or *war caused* a change; (b) the *extent* to which terrorism or war caused the change; and (c) specifically in the case of the particular language in Reliant, that there has been a *material worsening* of *current* conditions and, in the first of the two italicized clauses, that the change is not *temporary*. These issues create potentially significant obstacles to invoking the clause as a basis for termination.

As the Reliant transaction is an acquisition of Orion by Reliant and therefore the clause is not reciprocal, it is somewhat surprising that Reliant was able to negotiate "outs" for general changes caused by acts of terrorism or war, and it is to be expected that most sellers will vigorously resist such a provision. Granted, the effect of terrorism or war on the financial markets or business conditions could be unusually and unforeseeably severe, but sellers will likely object that the allocation to the seller of the risks of general changes caused by terrorism or war is arbitrary, particularly where, as in the Reliant transaction, other general changes in securities markets and the economy, regardless of their cause or severity, are for the account of the buyer. Moreover, by their very nature, acts of terrorism or war are unpredictable, and are as likely to occur the day after closing as the day before.

* * *

An alternative approach that would address a party's concern to preserve an escape clause in the face of major

market disruption caused by terrorism would be to include a "Dow Jones" clause in the acquisition agreement. Common in the late 1980s after the steep market drop that occurred on October 19, 1987, such a clause permits a party to walk away from a transaction if the Dow Jones Industrial Average (or other specified market index) falls by more than a specified number of points or more than a specified percentage.

* * *

Another formulation for which there is a precedent post-September 11 is to provide a right to terminate based upon an extended market shutdown, banking moratorium or similar event. Under an agreement dated as of October 8, 2001, between Burlington Resources Inc. and Canadian Hunter Exploration Ltd., Burlington is entitled to terminate the agreement if at the time all other conditions are satisfied, there is a general suspension of trading or general limitation on prices on any United States or Canadian national securities exchange, a declaration of a banking moratorium or general suspension of payments by banks, a limitation on extension of credit by banks or financial institutions, or a material worsening of any of these conditions, which continues for not less than ten days.

How parties choose to allocate these risks in future deals will be influenced by transactions that were signed prior to September 11 that involve companies that have been, or are alleged to have been, affected by the events of that date or their consequences. One such deal was USA Networks, Inc.'s proposed acquisition of National Leisure Group, Inc., a seller and distributor of cruise and vacation packages and provider of travel support solutions. On October 3, 2001, USA notified NLG that it had terminated the merger agreement and simultaneously commenced an action in Delaware Chancery Court seeking declaratory and injunctive relief confirming that its actions in

terminating the merger agreement with NLG were lawful. The grounds asserted by USA Networks were: (i) the termination of an allegedly material customer relationship and the receipt by NLG of various claims from that customer, and (ii) the alleged occurrence of a MAC, consisting of, inter alia, NLG's financial performance from signing to the date of termination, "as well as the effects and reasonably foreseeable future effects on NLG of the events of September 11 and their aftermath."

The MAC clause in the USA/NLG merger agreement did not contain any carve-outs for general economic, financial market or industry changes. Accordingly, the issue was relatively clear—had changes occurred, either as a result of the events of September 11 or other facts alleged by USA, that were or would reasonably be expected to be materially adverse to the financial condition, results of operations, assets, properties or business of NLG? Given the substantial reduction in corporate and vacation travel since September 11, the business of NLG, a non-reporting company, could well have been materially impacted, and the absence of any carve-outs from the MAC clause eliminated a possible line of defense for NLG. In any event, NLG must have concluded that a settlement was preferable to litigating USA's termination of the agreement, as on October 29, the parties announced a settlement that involved USA taking an equity stake in NLG and entering into a commercial deal to market NLG travel packages on the USA Travel Channel. It is unlikely that NLG's position under the merger agreement would have been much stronger had there been a carve-out for general financial or market changes, as the changes alleged by USA were specific to the business of NLG.

The issues would have been more complicated, and the parties might have acted differently, had there been a carve-out for general industry changes. In that situation, even if the changes alleged as a result of the events of September 11 were material, there would still have been a

> question whether the changes were general industry changes. And if in fact there were widespread adverse effects on companies in the industry, but the impacts on the target company were much more pronounced, would the acquiror have been comfortable exercising a right to terminate? The presence of absence of language excluding disproportionate impacts of general changes would likely have significant impact on the acquiror's analysis.
>
> In summary, the debate over the content of the material adverse change clause in merger and acquisition agreements will be more vigorous, stoked by the events of September 11, and cases like NLG and the earlier Tyson Foods case. The wording of the MAC clause may not look different in many post-September 11 deals than it did before, but the parties will be more conscious of the issues and the importance of the specific words used.

In addition to Section 3.15, which deals generally with material adverse changes affecting the Seller, Section 3.19 covers several specific matters that are considered significant (though not necessarily adverse) events for the Seller and may, individually or in the aggregate, constitute material adverse changes. Section 3.19 requires disclosure of such events that occurred after the date of the Balance Sheet but before the signing of the acquisition agreement, and Section 5.3 requires the Seller to prevent such events from occurring (to the extent it is within their power to do so) after the signing date but before the closing (for further discussion, see the Comment to Section 3.19). Together, Sections 3.15 and 3.19 require the Seller to disclose to the Buyer updated information concerning important developments in the business of the Seller after the date of the Balance Sheet.

8. If I really want to get out of the deal, what are my risks and what should my termination notice say? [Egan's M&A Nuggets pp. 192-193]

In the event that a buyer wrongfully terminates the purchase agreement or refuses to close, the buyer could be liable under Section 11.4 of the Model Agreement and under common law for breach of contract. *Rus, Inc. v. Bay Industries, Inc. and SAIC, Inc.*, 2004 WL 1240578 (S.D.N.Y. May 25, 2004),

was a breach of contract action arising out of the proposed sale by Rus. Inc. ("*Seller*") of a wholly owned subsidiary to Bay Industries, Inc. ("*Buyer*") and SAC, Inc. (Buyer's newco acquisition subsidiary) pursuant to a stock purchase agreement they entered into on January 29, 2001. Buyer refused to close the sale on the grounds that certain conditions to closing enumerated in the purchase agreement had not been satisfied by the Seller. Seller brought a breach of contract action, asserting that in fact all purchase agreement conditions to the closing had been fulfilled and seeking money damages from the Buyer for its failure to close pursuant to the purchase agreement. In a lengthy and detailed factual analysis in which the Court weighed the testimony of expert and party witnesses, the Court concluded that these closing conditions had been satisfied and that the real reason for the Buyer's decision to walk was Buyer's remorse – concern on the Buyer's part that it had over-extended itself financially and that it had made a bad deal. The Court found that the Buyer had breached the contract and awarded substantial damages to the Seller. The *Rus* case is interesting both for (i) its focus on the contemporaneous actions of the parties in weighing the materiality of the developments and the reasonableness of the actions in response and (ii) its analysis in calculating the damages awarded to Seller to compensate it for Buyer's breach of contract.

In *Russ* the two purchase agreement conditions to closing that were relied upon by Buyer in aborting the transaction were receipt of (1) a satisfactory Phase I environmental report and (2) two landlord consents. As to the Phase I environmental report, the purchase agreement only required that the report be delivered, which happened, and that "Buyer shall be *reasonably satisfied* therewith," which was the issue. The Court held that "*reasonably satisfied*" required that Buyer act in "good faith" in evaluating the issues raised by the report. After weighing testimony and noting that that (i) Seller had agreed to pay the cost of remediation, which was nominal in view of the size of the transaction and could have been completed prior to closing if Buyer had not agreed to postpone the work until after closing, (ii) there was no evidence of any material environmental liabilities or any governmental enforcement action, and (iii) the parties, their consultants and counsel did not act as if the environmental issues identified in the report were serious until Buyer decided to abort the deal, the Court found that the environmental issues were trivial and that Buyer was not acting in good faith and reasonably in refusing to close on the basis thereof.

As to the landlord consents, the Court found that (a) the landlords had initially declined to consent because Buyer's credit was not as good as Seller's, (b) after Seller had agreed to guarantee Buyer's leasehold obligations, the landlords agreed to consent, and (c) Buyer knew the written consents would be forthcoming when it declined to close. Thus, the Court found the landlord consents were no justification for Buyer not closing.

Finally, Buyer argued that the target's financial condition was deteriorating such that there had been a "material adverse change" that would entitle Buyer to abort the deal in accordance with the purchase agreement. The Court, noting that the Buyer was a strategic buyer whose owner testified that "short-term swings in profits" were not particularly significant as Buyer was focused on "long-term synergies" and that the material adverse change ground appeared to be an afterthought defense, found that the financial change concerns were little more than "buyer's remorse" and that Buyer's "belated effort…to renegotiate the purchase price further bolsters this conclusion, indicating [Buyer's] belief that it had agreed to too high a price."

On the issue of damages, the Court held that "[u]nder New York law, the measure of damages for the breach of a contract of sale is the difference between the contract price and the fair market value of the item or property being sold at the time of the breach…Fair market value means the price that a willing buyer would pay a willing seller in a fair transaction." The Court found that business had been seriously damaged as a result of its aborted sale, noting testimony to the effect that "sales suffered because employees were 'demotivated' and distracted by the uncertainty surrounding the pending transition in ownership….[the business] lost key personnel…and [c]ompetitors took advantage to make inroads into [its] customer base." At the time of trial Seller had been unable to find another purchaser for the business, and argued that the damages should be equal to the difference between the purchase price and the liquidation value of the assets of the business. The Court found that Seller's inability to find a purchaser by the time of trial did not mean that the business had no going concern value. The Court ultimately found that the value of the business was 50% above its liquidation value, and awarded damages equal to the difference between that value and what Seller would have received if Buyer had performed under the purchase agreement.

9. Can a seller rely on the private equity sponsor's balance sheet touted during the negotiations? Well capitalized buyers often seek to effect acquisitions through newly formed and thinly capitalized affiliates. In the process, seller may be shown the strong balance sheet of the controlling entity behind the acquisition; but if the buyer gets cold feet, can the seller reach the balance sheet it saw as the deal was being negotiated? [Egan's M&A Nuggets pp. 162-163]

In *James Cable, LLC, v. Millennium Digital Media Systems d/b/a "Broadstripe,"* 2009 WL 1638634 (Del. Ch. June 11, 2009), a cable company agreed to sell substantially all of its assets to another company and, before the transaction closed, the market value of cable industry assets declined. The buyer wrote seller alleging breaches of asset purchase agreement representations and refusing to close. The seller then sued both the buyer (which then filed for bankruptcy) and the buyer's controlling stockholder (which was not a party to either the asset purchase agreement or any written agreement to provide funding) "in an attempt to reach the deeper pockets of that company" and alleging *inter alia* that the controlling stockholder promised that it would provide funding for the transaction and wrongfully induced buyer to default on its purchase obligation. While the case against buyer was stayed under the Bankruptcy Code, the case proceeded against the controlling stockholder.

In granting the controlling stockholder's motion to dismiss, the Chancery Court stated that in order to succeed on its tortuous interference claim, seller had to allege "(1) a valid contract, (2) about which the defendants have knowledge, (3) an intentional act by defendants that is a significant factor in causing the breach of the [contract], (4) done without justification, and (5) which causes injury." The Court went on to note that Delaware law "shields companies affiliated through common ownership from tortious interference with contract claims when the companies act in furtherance of their shared legitimate business interests." The Court also noted that to overcome the "affiliate privilege" a plaintiff had to adequately plead that the defendant "was motivated by some malicious or other bad faith purpose," which seller had failed to do.

Seller also argued that the controlling stockholder was liable on a promissory estoppel theory because it made statements to induce seller to enter into the asset purchase agreement. The Court held that the controlling

stockholder failed to show that there was a "real promise" that was "reasonably definite and certain," and commented that: "In sophisticated merger and acquisition activity with large amounts of money at stake, such as here, the parties typically reduce even seemingly insignificant matters to writing. Parties generally include an integration clause, like the one found in the [asset purchase agreement before the Court and § 13.7 of the Model Agreement] that expressly states the written agreements compose the entire understanding of the parties." In rejecting the promissory estoppel claim, the Court commented that if the controlling stockholder had promised to provide financing, there would have been a detailed writing spelling out its obligations.

10. Can you lie in M&A negotiations? [Egan's M&A Nuggets pp. 229-230]

Lawyer ethical duties preclude lawyers from making misrepresentations in negotiations. Securities laws also sanction misrepresentations and omissions in the acquisition of securities.

Further, Delaware common law also embraces the **"forthright negotiator principle of contract interpretation."** In *United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810 (Del. Ch. 2007), the dispute centered on whether the merger agreement limited seller's remedy to the reverse breakup fee or whether seller could seek specific performance. The Court determined that the merger agreement was ambiguous as to whether the parties had agreed that specific performance was intended to be an available remedy. As a result, the Court reviewed the extrinsic evidence, including the drafting and negotiating history of the merger agreement and related documents, and determined that the extrinsic evidence was not clear enough to conclude that there was a single, shared understanding with respect to the availability of specific performance under the merger agreement. Further, the Court determined that the evidence concerning the negotiations demonstrated that under the ***"forthright negotiator"*** principle of contract interpretation (i) the buyer did not know or have a reason to know that seller believed specific performance was an available remedy under the merger agreement, (ii) seller knew or should have known that buyer believed that specific performance was not to be available, and (iii) in the face of the foregoing, seller failed to clarify its position affirmatively. Accordingly, the Court concluded that seller had failed to

meet its burden of demonstrating that the common understanding of the parties permitted specific performance and denied specific performance. *See* XIII Deal Points (The Newsletter of the ABA Bus. L. Sec. Committee on Negotiated Acquisitions) at 19-20 (Spring 2008); *see DCV Holdings, Inc. v. ConAgra, Inc.*, 2005 Del. Super. LEXIS 88 (March 24, 2005) (In the course of reading a knowledge qualifier into a stock purchase agreement no undisclosed liabilities representation that was found to be ambiguous, a Delaware Superior Court wrote: "A contract will be construed against a party who maintains its own interpretation of an agreement and fails to inform the other party of that interpretation"); *cf. Julian v. Eastern States Construction Service, Inc.* (Del. Ch. No. 1892-VCP July 8, 2008) ("*forthright negotiator*" principle applied in construction of buyout rights in stockholder agreement for family owned business).

11. Do claims for director fiduciary duty breaches survive a merger? [Egan's Fiduciary Duties pp. 54-55]

Questions arise with respect to the effect of a merger in which the corporation is not the acquiring entity on a derivative action. Under Delaware law, in the absence of fraud, "the effect of a merger . . . is normally to deprive a shareholder of the merged corporation of standing to maintain a derivative action."[16] Allegations that a Board Chairman foiled a

[16] *Feldman v. Cutaia*, 951 A.2d 727 (Del. 2008) (claim by shareholder that invalid grant of options resulted in dilution, which resulted in shareholder getting less value in merger, was derivative and did not survive merger); *Lewis v. Ward*, 852 A.2d 896 (Del. 2004); *Lewis v. Anderson*, 477 A.2d 1040, 1047–49 (Del. 1984); *In re Merrill Lynch & Co., Inc. Sec., Derivative and ERISA Litig.*, Master File No. 07 Civ. 9633 (JSR) (S.D.N.Y. Feb. 17, 2009); *In re Countrywide Fin. Corp. S'holders Litig.*, C.A. No. 3464-VCN, 2008 WL 4173839 (Del. Ch. Sept. 10, 2008); *In re Countrywide Fin. Corp. Derivative Litig.*, Civ. No. 07-372-SLR (D. Del. Oct. 7, 2008); *see Elloway v. Pate*, 238 S.W.3d 882, 900 (Tex. App.—Houston [14th Dist.] 2007, no pet.), in which a Texas court applying Delaware law held that a merger eliminated standing to bring a derivative action, but not a direct action, and explained: "A derivative claim is brought by a stockholder, on behalf of the corporation, to recover harm done to the corporation. *Tooley v. Donaldson, Lufkin & Jenrette*, 845 A.2d 1031, 1036 (Del. 2004). A stockholder's direct claim must be independent of any alleged injury to the corporation. *Id.* at 1039. If the stockholder's claim is derivative, the stockholder loses standing to pursue his claim upon accomplishment of the merger. *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1244-45 (Del. 1999). A stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such claim even after the merger at issue has been consummated. *Id.* at 1245. To state a direct claim with respect to a merger, a stockholder must challenge the validity of the merger itself, usually by charging the directors with breaches of fiduciary duty in unfair dealing and/or

potential superior bid by demanding a position for himself with the superior bidder (an entrenchment claim) were derivative in nature and did not survive a merger with another bidder.[17] A narrow exception to Delaware's general non-survival rule exists: a "stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such a claim even after the merger at issue has been consummated."[18]

The effect of a merger in which the corporation is not the acquiring entity on a derivative action is not as clear under Texas law. Like Delaware, the Federal Rules of Civil Procedure and Texas' prior derivative action provisions in the TBCA have been interpreted to require that the claimant in a derivative case remain a shareholder throughout the course of the derivative claim,[19] which requirement would not be satisfied where a

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unfair price. *Id.* at 1245." *Cf. Pate v. Elloway*, No. 01-03-00187-CV, 2003 WL 22682422 (Tex. App.—Houston [1st Dist.] Nov. 13, 2003, pet. denied).

[17] *In re NYMEX Shareholder Litigation*, C.A. No. 3621-VCN (Del. Ch. Sept. 30, 2009).

[18] *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1245 (Del. 1999).

[19] FED. R. CIV. P. 23.1; *Schilling v. Belcher*, 582 F.2d 995, 999 (5th Cir. 1978) (noting "the [stock] ownership requirement continues throughout the life of the suit"); *Romero v. US Unwired, Inc.*, No. 04-2312, 2006 WL 2366342, at *5 (E.D. La. Aug. 11, 2006) (slip op.) (holding that merger divested shareholder plaintiff of standing to pursue derivative claim under Fed. R. Civ. P. 23.1 and dismissing suit); *Zauber v. Murray Sav. Ass'n*, 591 S.W.2d 932, 937-38 (Tex. Civ. App. 1979) ("The requirement in article [TBCA] 5.14(B) [as it existed in 1979] that in order to bring a derivative suit a plaintiff must have been a shareholder at the time of the wrongful transaction, is only a minimum requirement. The federal rule governing derivative suits, which contains similar requirements to article 5.14(B), has been construed to include a further requirement that shareholder status be maintained throughout the suit. [citations omitted] The reasoning behind allowing a shareholder to maintain a suit in the name of the corporation when those in control wrongfully refuse to maintain it is that a shareholder has a proprietary interest in the corporation. Therefore, when a shareholder sues, he is protecting his own interests a well as those of the corporation. If a shareholder voluntarily disposes of his shares after instituting a derivative action, he necessarily destroys the technical foundation of his right to maintain the action. [citation omitted] If, on the other hand, a shareholder's status is involuntarily destroyed, a court of equity must determine whether the status was destroyed without a valid business purpose: for example, was the action taken merely to defeat the plaintiff's standing to maintain the suit? * * * If no valid business purpose exists, a court of equity will consider the destruction of a stockholder's status a nullity and allow him to proceed with the suit in the name of the corporation. Therefore, on remand of this suit, a finding that appellant has failed to maintain his status as shareholder is dependent upon findings that the disposition of the stock was voluntary or, though involuntary, that the corporation's termination proceeding was instituted to accomplish a valid business purpose, rather than to dispose of the derivative suit by a reverse stock split.").

derivative plaintiff's shares in the corporation are converted in the merger into cash or securities of another entity. Only one Texas court has ruled on the merger survival issue under the derivative provisions in the current Texas Corporate Statutes, holding that, at least in a cash-out merger, the right of a shareholder to bring a derivative action on behalf of the non-surviving corporation does not survive the merger.[20] Whereas Delaware law explicitly allows for direct suit in such cases, *Gearhart* held that under Texas law fiduciary claims in connection with a merger are the right of the corporation itself, not individual shareholders.[21]

Courtesy of Byron F. Egan, Jackson Walker LLP

[20] *Somers v. Crane*, No. 01-08-00119-CV, 2009 WL 793751 (Tex. App.—Houston [1st Dist.] Mar. 26, 2009, no pet. h.). TBCA art. 5.03(M) provides that for the purposes of TBCA art. 5.03: "To the extent a shareholder of a corporation has standing to institute or maintain derivative litigation on or behalf of the corporation immediately before a merger, nothing in this article may be construed to limit or extinguish the shareholder's standing." (Substantially the same language is included in TBOC § 21.552(b)). At least one federal court interpreting Texas law has suggested that under TBCA art. 5.03(M) a shareholder who could have properly brought a derivative suit prior to a merger will maintain that right, even after a merger has rendered the corporation in question nonexistent. *Marron v. Ream*, Civil Action No. H-06-1394, 2006 U.S. Dist. LEXIS 72831, at *23 (S.D. Tex. May 8, 2006). But the *Somers* opinion dismissed this analysis, holding that *Marron* did not squarely address the issue of standing and that the federal court's suggestion that 5.03(M) might support survival was merely dicta. *Somers*, No. 01-08-00119-CV at 21. *Somers* also held that "because of the abundant authority stating that a director's or officer's fiduciary duty runs only to the corporation, not to individual shareholders, we decline to recognize the existence of a fiduciary relationship owed directly by a director to a shareholder in the context of a cash-out merger" and, thus, that a direct class action could not be brought against directors and officers for their role in a cash-out merger. *Id.* at 13.

[21] *Gearhart Indus., Inc. v. Smith Int'l. Inc.*, 741 F.2d 707,721 (5th Cir. 1984).

APPENDIX B

"EGAN ON ENTITIES"

This bulletin, called Egan on Entities, contains introductions to Byron Egan's recent significant writings in four areas of the law relating to business entities, including how they are formed, governed and combined with other entities.[22] These writings contain practical insights regarding these subjects developed from his law firm practice and his interaction with others, as well as a thorough analysis of statutory and case law from which these practical insights have been developed.

Full versions of the writings referenced below can be found in the links identified below.

For further information or to provide your suggestions for additional bulletins, feel free to contact Mr. Egan directly at 214 953-5727, or by email at began@jw.com. Additionally, a listing of Mr. Egan's writings available online may be accessed at: www.jw.com/site/jsp/attyinfo.jsp?id=77.

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1. CHOICE OF ENTITY AND FORMATION

EXCERPTED FROM: "Choice of Entity Decision Tree In Troubled Times" – prepared for a May 22, 2009 program in San Antonio at the TexasBarCLE & Business Law Section of State Bar of Texas' program on Choice of Entity In Troubled Times. Published on the JW website and full text available at: www.jw.com/site/jsp/ publicationinfo.jsp?id =1175

Key Issues Covered:

- Key factors in entity selection
- Summaries of key provisions of Texas and Delaware laws relating to
  - Corporations
  - General Partnerships
  - Limited Partnerships
  - Limited Liability Partnerships
  - Limited Liability Companies
- Summaries of U.S. and Texas tax treatment of entities

See also *"Good Faith, Fair Dealing and Other Contractual and Fiduciary Issues"* – prepared for a July 23, 2009 program in Austin at the UT Law 2009 Partnerships and LLCs Conference. Published on the JW website and full text available at: www.jw.com/site/jsp/publicationinfo.jsp?id=1220

In selecting a form of business entity in which to engage in business in the United States, the organizer or initial owners should consider the following five business entity forms:

- Corporation
- General Partnership
- Limited Partnership
- Limited Liability Partnership ("LLP")
- Limited Liability Company ("LLC")

The form of business entity most advantageous in a particular situation depends on the objectives of the business for which the entity is being organized. In most situations, the focus will be on how the entity and its owners will be taxed and the extent to which the entity will shield the owners of the business from liabilities arising out of its activities.

The Texas Legislature has enacted the Texas Business Organizations Code (the "TBOC") to codify the Texas statutes relating to business entities referenced above, together with the Texas statutes governing the formation and operation of other for-profit and non-profit private sector entities. The TBOC is applicable for entities formed or converting under Texas law after January 1, 2006. Entities in existence on January 1, 2006 must conform to TBOC by January 1, 2010, but may continue to be governed by the Texas source statutes until then.

Federal and state taxation of an entity and its owners for entity income is a major factor in the selection of the form of entity for a particular situation. Under the Internal Revenue Code of 1986 and the "Check-the-Box" regulations promulgated by the Internal Revenue Service, an unincorporated business entity may be classified as an "association" taxable as a corporation subject to income taxes at the corporate level ranging from 15% to 35% of taxable net income, absent a valid S corporation status election, which is in addition to any taxation which may be imposed on the owner as a result of distributions from the business entity. Alternatively, the entity may be classified as a partnership, a non-taxable "flow-through" entity in which taxation is imposed only at the ownership level. Although generally a corporation may be classified only as a corporation for federal income tax purposes, an LLC or partnership may elect whether to be classified as a partnership. A single-owner LLC is disregarded as a separate entity for federal income tax purposes unless it elects otherwise.

Texas does not have a state personal income tax. The Texas Legislature has replaced the Texas franchise tax on corporations and LLCs with a novel business entity tax called the "Margin Tax," which is imposed on all business entities other than general partnerships wholly owned by individuals and certain "passive entities." Essentially, the calculation of the Margin Tax is based on a taxable entity's, or unitary group's, gross receipts after deductions for either (x) compensation or (y) cost of goods sold,

provided that the "tax base" for the Margin Tax may not exceed 70% of the entity's total revenues. This "tax base" is apportioned to Texas by multiplying the tax base by a fraction of which the numerator is Texas gross receipts and the denominator is aggregate gross receipts. The tax rate applied to the Texas portion of the tax base is 1% for all taxpayers, except a narrowly defined group of retail and wholesale businesses that will pay a ½ of 1% rate.

The enactment of the Margin Tax changes the calculus for entity selections, but not necessarily the result. The LLC has become more attractive as it can elect to be taxed as a corporation or partnership for federal income tax purposes and has the same Margin Tax treatment as most limited partnerships, but the uncertainties as to an LLC's treatment for self-employment purposes continue to restrict its desirability in some situations.

For the full version, please go to the Jackson Walker L.L.P. website, www.jw.com, where the full text is available at: www.jw.com/site/jsp/publicationinfo.jsp?id=1175.

2. CORPORATE GOVERNANCE

EXCERPTED FROM: "Fiduciary Duties of Corporate Directors and Officers in Texas" – 43 Texas Journal of Business Law 45 (Spring 2009). Published on the JW website and full text available at: www.jw.com/site/jsp/ publicationinfo.jsp?id=1230

Key Issues Covered:

- Fiduciary duties of directors and officers generally in both Texas and Delaware
- Fiduciary duties in insolvency situations
- Fiduciary duties regarding compensation
- Fiduciary duties regarding mergers and acquisitions
- Fiduciary duties regarding alternative entities

See also *"Rule of Law or Rule of Awe: Fiduciary Duties in M&A Transactions"* – prepared for an October 16, 2009 program in Dallas at the UT School of Law 2009 Mergers and Acquisitions Institute. Published on the JW website and full text available at: www.jw.com/site/jsp/ publicationinfo.jsp?id=1263

The conduct of corporate directors and officers is subject to particular scrutiny in the context of executive compensation and other affiliated party transactions, business combinations (whether friendly or hostile), when the corporation is charged with illegal conduct, and when the corporation is insolvent or in the zone of insolvency. The high profile stories of how much corporations are paying their executive officers, corporate scandals, bankruptcies and related developments have further focused attention on how directors and officers discharge their duties, and have caused much reexamination of how corporations are governed and how they relate to their shareholders and creditors. Where the government intervenes (by investment or otherwise) or threatens to do so, the scrutiny intensifies, but the courts appear to resolve the controversies by application of traditional principles while recognizing the 800-pound gorilla in the room.

The individuals who serve in leadership roles for corporations are fiduciaries in relation to the corporation and its owners. These troubled times make it appropriate to focus upon the fiduciary and other duties of directors and officers, including their duties of care and loyalty. Increasingly the courts are applying principals articulated in cases involving mergers and acquisitions ("M&A") to cases involving executive compensation, perhaps because both areas often involve conflicts of interest and self-dealing or because in Delaware, where many of the cases are tried, the same judges are writing significant opinions in both areas. Director and officer fiduciary duties are generally owed to the corporation and its shareholders, but when the corporation is insolvent, the constituencies claiming to be beneficiaries of those duties may expand to include the entity's creditors.

While federal securities laws and stock exchange listing requirements have mandated changes in corporate governance practices, our focus will be on state corporate statutes and common law. Our focus is in the context of entities organized under the applicable Delaware and Texas statutes.

For the full version, please go to the Jackson Walker L.L.P. website, www.jw.com, where the full text is available at: www.jw.com/site/jsp/publicationinfo.jsp?id=1230.

3. MERGERS & ACQUISITIONS

EXCERPTED FROM: "Acquisition Agreement Issues" – prepared for Penn State Law and City Bar Center for CLE, New York City Bar, Sixth Annual Institute on Corporate, Securities, and Related Aspects of Mergers and Acquisitions, New York, NY, Sept. 25, 2009, available at: www.jw.com/site/jsp/publicationinfo.jsp?id=1244

Key Issues Covered:

- Alternative structures for sales of businesses
- Successor liability
- Form of asset purchase agreement with commentary

Buying or selling a business in uncertain times, including the purchase of a division or a subsidiary, revolves around a purchase agreement between the buyer and the selling entity and sometimes its owners. Purchases of assets are characterized by the acquisition by the buyer of specified assets from an entity, which may or may not represent all or substantially all of its assets, and the assumption by the buyer of specified liabilities of the seller, which typically do not represent all of the liabilities of the seller. When the parties choose to structure an acquisition as an asset purchase, there are unique drafting and negotiating issues regarding the specification of which assets and liabilities are transferred to the buyer, as well as the representations, closing conditions, indemnification and other provisions essential to memorializing the bargain reached by the parties. There are also statutory (e.g., bulk sales and fraudulent transfer statutes) and common law issues (e.g., de facto merger and other successor liability theories) unique to asset purchase transactions that could result in an asset purchaser being held liable for liabilities of the seller which it did not agree to assume.

A number of things can happen during the period between the signing of an asset purchase agreement and the closing of the transaction that can cause a buyer to have second thoughts about the transaction. For example, the buyer might discover material misstatements or omissions in the seller's representations and warranties, or events might occur, such as the filing of litigation or an assessment of taxes, that could result in a material liability

or, at the very least, additional costs that had not been anticipated. There may also be developments that could seriously affect the future prospects of the business to be purchased, such as a significant downturn in its revenues or earnings or the adoption of governmental regulations that could adversely impact the entire industry in which the target operates.

The buyer initially will need to assess the potential impact of any such misstatement, omission or event. If a potential problem can be quantified, the analysis will be somewhat easier. However, the impact in many situations will not be susceptible to quantification, making it difficult to determine materiality and to assess the extent of the buyer's exposure. Whatever the source of the matter, the buyer may want to terminate the acquisition agreement or, alternatively, to close the transaction and seek recovery from the seller. If the buyer wants to terminate the agreement, how strong is its legal position and how great is the risk that the seller will dispute termination and commence a proceeding to seek damages or compel the buyer to proceed with the acquisition? If the buyer wants to close, could it be held responsible for the problem and, if so, what is the likelihood of recovering any resulting damage or loss against the seller? Will closing the transaction with knowledge of the misstatement, omission or event have any bearing on the likelihood of recovering? The dilemma facing a buyer under these circumstances seems to be occurring more often in recent years.

The issues to be dealt with by the parties to an acquisition transaction will depend somewhat on the structure of the transaction and the wording of the acquisition agreement. Regardless of the wording of the agreement, however, there are some situations in which a buyer can become responsible for a seller's liabilities under successor liability doctrines. The analysis of these issues is somewhat more complicated in the acquisition of assets, whether it be the acquisition of a division or the purchase of all the assets of a seller. The paper has the following topics:

This paper includes:

- An overview of the three basic forms of business acquisitions:
    - Statutory business combinations (e.g., mergers, consolidations and share exchanges);

  - Stock purchases; and
  - Asset purchases.

- Introductory matters concerning the reasons for structuring the transaction as an asset purchase.

- A discussion of the various successor liability doctrines and some suggested means of minimizing the risk.

- An initial draft of certain key provisions of an Asset Purchase Agreement which focuses on the definition and solution of the basic issues in any asset purchase: (1) what assets are being acquired and what liabilities are being assumed, (2) what assets and liabilities are being left behind, (3) what are the conditions of the obligations of the parties to consummate the transaction and (4) what are the indemnification obligations of the parties. While these matters are always deal specific, some generalizations can be made and common problems identified.

For the full version, please go to the Jackson Walker L.L.P. website, www.jw.com, where the full text is available at: www.jw.com/site/jsp/publicationinfo.jsp?id=1043.

4. SECURITIES LAWS

EXCERPTED FROM: "Major Themes of the Sarbanes-Oxley Act" – 42 Texas Journal of Business Law 339 (Winter 2008). Published on the JW website and full text available at: www.jw.com/site/jsp/publicationinfo.jsp?id=1186

Key Issues Covered:

- Effects of the Sarbanes-Oxley Act of 2002 ("SOX") on issuers, directors and professionals generally
- SOX audit committee provisions
- SOX auditor independence provisions
- SOX prohibitions on misleading statements to auditors
- SOX internal controls provisions
- Attorney responsibilities under SOX
- Letters to auditors regarding loss contingencies
- Attorney-client and work product privilege considerations

The Sarbanes-Oxley Act of 2002 ("SOX") was trumpeted by the politicians and in the media as a "tough new corporate fraud bill" in response to the corporate scandals that preceded it and as a means to protect investors by improving the accuracy and reliability of corporate disclosures. Among other things, SOX amended the Securities Exchange Act of 1934 (the "1934 Act") and the Securities Act of 1933. Although SOX does have some specific provisions, and generally establishes some important public policy changes, it has been implemented in large part through rules adopted and to be adopted by the Securities and Exchange Commission ("SEC") and the Public Company Accounting Oversight Board ("PCAOB"), which have impacted auditing standards and have increased scrutiny on auditors' independence and procedures to verify company financial statement positions and representations. Further, while SOX is by its terms generally applicable only to public companies, its principles are being applied by the marketplace to privately held companies and nonprofit entities.

Following the enactment of SOX and the adoption of rules thereunder, the role of independent auditors in detecting financial statement fraud within public companies has received enhanced scrutiny. In turn, companies are expected both to implement controls for dealing with alleged fraud internally and to provide their auditors with detailed information on a wide range of corporate issues. Companies involve legal counsel, both inside and outside, for a wide variety of tasks, from conducting investigations of alleged fraud to dealing with employee issues (including whistleblower complaints) and advising directors on their duties in connection with corporate transactions. Auditors are increasingly asking for information regarding these often privileged communications to supplement their reliance on management representations. Making such privileged information available to auditors, however, subjects companies to the risk of loss of attorney client and work product privileges, which can provide a road-map to success for adversaries in civil litigation.

Further, in providing such information to auditors, the provider must comply with the requirements of Section 303 of SOX and expanded Rule 13b2-2 under the 1934 Act adopted pursuant to SOX §303. The SOX §303 requirements specifically prohibit officers and directors, and "persons acting under [their] direction," from coercing, manipulating, misleading or fraudulently influencing an auditor "engaged in the performance of an audit" of the issuer's financial statements when the officer, director or other person "knew or should have known" that the action, if successful, could result in rendering the issuer's financial statements filed with the SEC materially misleading. Since attorneys and other mergers and acquisitions professionals representing a corporation are usually engaged by, and are acting at the direction of, its directors or officers, they are subject to the SOX §303 Requirements. The SEC has demonstrated its willingness to bring sanction proceedings against lawyers when they have been perceived to have failed in their responsibilities.

The SOX §303 requirements should influence an attorney in communicating with accountants, and reinforce the importance of providing meaningful information to auditors and clients. The SOX §303 requirements, however, should not be viewed as repudiating or supplanting the ABA Statement of Policy regarding Lawyers' Responses to Auditors' Requests for Information regarding client loss contingencies. Resulting

from a compromise reached in 1976 between the lawyers and the accountants, this ABA Statement of Policy provides a framework under which lawyers can provide information to auditors regarding client loss contingencies in connection with their examination of client financial statements, while minimizing the risk of loss of attorney-client privilege in the process.

In addition, the requirements of SOX §307 are specifically applicable to attorneys. The SEC rules under SOX §307 generally provide that, in the event that an attorney has "credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation [of any U.S. law or fiduciary duty] has occurred, is ongoing, or is about to occur," the attorney has a duty to seek to remedy the problem by "reporting up the ladder" within the issuer to the issuer's chief legal officer, or to both the chief legal officer and the chief executive officer, or if those executives do not respond appropriately, to the issuer's board of directors or an appropriate committee thereof. SEC rulemaking and enforcement actions post-SOX attempt to place lawyers in the role of "gatekeepers" or "sentries of the marketplace" whose responsibilities include "ensuring that our markets are clean." These SEC actions will directly affect the role of the lawyer in dealing with clients, auditors, M&A professionals and others.

For the full version, please go to the Jackson Walker L.L.P. website, www.jw.com, where the full text is available at: www.jw.com/site/jsp/publicationinfo.jsp?id=1186.

Courtesy of Byron F. Egan, Jackson Walker LLP

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Mergers and Acquisitions Law 2010 discusses the key upcoming trends in M&A law for 2010, highlighting the major milestones over the past year and providing overall thought leadership for the year ahead. Featuring partners from some of the nation's leading law firms, these experts discuss recent changes in laws, decisions, and policies that have affected the practice of mergers and acquisitions law, as well as recent case decisions that will impact the future scope of this ever-changing area of law. These authors identify the major hurdles their clients will face in 2010 and the most significant changes they are looking to employ in their strategy over the upcoming year.

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